FULL COMMITTEE HEARING ON THE IMPACT OF FINANCIAL REGULATORY RESTRUCTURING ON SMALL BUSINESSES AND COMMUNITY LENDERS

HEARING

BEFORE THE

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FULL COMMITTEE HEARING ON THE IMPACT OF FINANCIAL REGULATORY RESTRUCTURING ON SMALL BUSINESSES AND COMMUNITY LENDERS

Wednesday, September 23, 2009

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON SMALL BUSINESS,
Washington, DC.

The Committee met, pursuant to call, at 1:00 p.m., in Room 2360, Rayburn House Office Building, Hon. Nydia M. Velázquez [Chair of the Committee] Presiding.

Present: Representatives Velázquez, Moore, Dahlkemper, Schrader, Clarke, Ellsworth, Bright, Halvorson, Graves, Westmoreland, Luetkemeyer, and Coffman.

Chairwoman VELÁZQUEZ. I call this hearing to order.

One year ago this month, we saw the largest bankruptcy in United States' history when Lehman Brothers filed for Chapter 11. The following weeks were a whirlwind of activity. The FDIC seized Washington Mutual, selling the company's banking assets to JPMorgan Chase. Wachovia was acquired by Wells Fargo and Merrill Lynch, by Bank of America. Attempting to provide relief to our teetering financial system, Congress passed and President Bush signed into law the $700 billion TARP legislation.

Since then, it has become evident that the problems leading up to this crisis did not accumulate overnight. In fact, flaws in our risk management systems, both governmental regulations and private mechanisms, had been growing for decades.

In coming weeks, Congress and the administration will examine options for strengthening our regulatory structure. This is long overdue; the gaps in the system have grown too large to be ignored. We cannot count on current regulations to prevent another crisis.

While considered by many an issue for the financial services industry, how we address those gaps will be critical for all small businesses. It is imperative that as we look at alternatives for updating our financial regulations, we carefully consider how these changes might affect entrepreneurs.

Small businesses rely on the healthy functioning of our financial systems in order to access capital. New rules governing how financial institutions extend credit will directly affect entrepreneurs seeking loans at affordable rates. The biggest challenge facing small firms right now is access to affordable capital. We must be careful that regulatory changes do not exacerbate the current capital shortage and undercut our recovery as it begins to take hold.

Likewise, financial regulatory reform could unintentionally touch sectors of the small business community that we do not think of as financial institutions. Businesses that allow customers to pay for goods and services after delivery are essentially extending credit. Congress and the administration must be careful not to define the term "credit" too broadly. Otherwise, businesses like home builders, physicians, and others may face new rules that were not meant for them.

Small businesses come in all shapes and sizes and there are many in the financial sector. Community banks and credit unions could see their business models profoundly affected by many of the proposed changes. Small firms in the financial sector often face higher compliance costs than their larger competitors. Several proposals would result in small lenders answering to a new regulatory entity.

I expect some of our witnesses today will testify that small lenders bear less responsibility for the recent turmoil and, therefore, should not carry the brunt of new regulations. This argument seems to at least carry some credibility. The committee should consider it carefully as we proceed.

As both lenders and borrowers, small businesses have much at stake when it comes to regulatory reform. The financial crisis of last year and the recession it triggered have hit small firms hard. As much as anyone, entrepreneurs want these problems fixed so that financial markets can again play their vital role in promoting commerce.

Numerous strategies have been floated for restoring transparency and stability to our financial systems. Depending on how they are crafted, these proposals could touch every sector of the American economy. For these reasons, we have invited representatives from a range of industries to testify. It is my hope that their testimony will add important perspectives to our discussion.

On that note I would like to take the opportunity to thank all the witnesses for taking time out of your busy schedule to be with us here today.

And I yield to the ranking member, Mr. Graves, for an opening statement.

[The statement of Chairwoman Velázquez is included in the appendix.]

Mr. GRAVES. Thank you, Madam Chair, and I would like to thank you for holding this important hearing on the debate that is going to occur about restructuring the regulatory oversight of America's financial sector. Given the fact that the financial services sector contributed more than a third of corporate profits in this country during the last decade, it is a significant debate.

No one can question that the events affecting Wall Street last year had consequences on the overall American economy. Once credit becomes unavailable, the modern economy comes to a grinding halt. Consumers and businesses do not buy, manufacturers do not sell, and unemployment skyrockets.

Any reform to the financial regulatory process must meet two key objectives. First, it must provide for an efficient operation of the financial markets; and second, small businesses, the prime generator of new jobs in the economy, must have access to capital.

Competitive markets need full information to operate properly. To the extent that regulatory reform improves the information available to all parties that use the financial markets, it will be beneficial. That benefit must be weighed against the cost of providing information.

Much of the focus on financial regulatory reform proposals address either protecting consumers or preventing one or a group of institutions from creating systemic risk leading to the collapse of capital and the credit markets. However, little has been said on the impact that such regulatory oversight might have on the access to capital for small businesses. If the regulatory reform inhibits the ability of small businesses to obtain credit or access needed capital, the regulation will have an adverse long-term consequence on the ability of the economy to grow.

A famous philosopher once said that "Those who cannot remember the past are condemned to repeat it." Whatever the outcome of the debate on restructuring the regulation of the financial sector, we cannot repeat the mistakes of the past. Given the fact that financial panics have periodically occurred in this country going back to 1837, achieving a regulatory restructuring that ensures Congress does not repeat the mistakes of the past will be one of our most difficult tasks.

I again would like to thank the Chairwoman for holding this important hearing, and I yield back.

[The statement of Mr. Graves is included in the appendix.]

Chairwoman VELÁZQUEZ. Now I welcome Mr. Robert Harris, the Managing Director of Harris, Cotherman, Jones, Price & Associates in Vero Beach, Florida. He is also the Vice Chair for the American Institute of Certified Public Accountants, the national professional association of certified public accountants. The AICPA has more than 330,000 members.

Welcome, sir. And you have 5 minutes to make your statement.

STATEMENT OF ROBERT R. HARRIS

Mr. HARRIS. Chairwoman Velázquez, Ranking Member Graves, members of the committee. My name is Robert R. Harris and I am Vice Chairman with the American Institute of Certified Public Accountants. I am a CPA and a partner in the CPA firm of Harris, Cotherman, Jones, Price & Associates. We are located in Vero Beach, Florida, and are a small firm with 11 CPAs. My firm's clients are primarily small businesses and individuals. We do financial planning and tax service for most of these clients.

I am here today representing the American Institute of CPAs. AICPA is the national professional association of CPAs with more than 360,000 CPA members in business, industry, public practice, government, education, student affiliates, and international associates.

As a result of the economic crisis precipitated by the subprime lending, the administration and Congress felt that financial regulatory restructuring was necessary. The administration called for a new regulatory scheme that encompasses strong vibrant financial markets operating under transparent fairly administered rules that protect America's consumers and our economy from the devastating breakdown that we have witnessed in recent years.

The administration also said that to accomplish this goal it would be necessary to seek a careful balance that will allow our markets to promote innovation while discouraging abuse. To this end, Congress is looking at a number of financial activities with an eye towards how to appropriately and adequately regulate those activities.

The AICPA supports the goal of enhanced consumer protection, but we believe that it is critical to consider the plan's effect on small business to ensure that it does not stifle the innovation, creativity and inventiveness of the American entrepreneur that has driven our economic engine.

In this context, I would like to discuss The Consumer Financial Protection Act of 2009, H.R. 3126, which would create the Consumer Financial Protection Agency, or CFPA, and its effect on small business from the point of view of a CPA.

The stated aim of the consumer protection bill is to protect consumers by consolidating financial consumer protection in one agency. This would be a safeguard against consumers getting inappropriate loans that they could not afford repay. But the bill is much broader than protecting consumers when they borrow money.

The CFPA, as introduced, would cover most CPAs because its scope of authority includes tax return preparation, tax advice, financial planning, and pro bono financial literacy activities. The accounting profession's pro bono financial literacy programs, "360 Degrees of Financial Literacy" and FeedthePig.org, which are designed to teach consumers and young people how to make smart decisions would be covered by the bill. Our own Lisa Baskfield, a CPA from Minnesota, was recently awarded the civilian service medal for providing pro bono financial access to more than 2,000 armed services members. Her advice would have been covered under this bill.

Many of the members are affiliated with CPA firms that are small businesses and will be adversely affected by the bill, and many of their clients are small businesses, sole proprietorships and partnerships. It is impossible to separate the advice and tax service given to these small businesses from the advice and tax services given to the owners. They both are covered by the bill—thus, both would be covered by this bill.

Additionally, any person who provides a material service to a covered person such as a financial institution is included in the definition of a covered person. My practice of forensic accounting would subject me to the CFPA when I do a financial audit of a lender making consumer loans even though I do not have direct dealings with the consumers and provide no services to consumers.

As a CPA, I can tell you that CPAs are heavily and effectively regulated by three sources. State boards of accountancy, the Internal Revenue Service, and the AICPA. This regulatory structure protects consumers first with the first rule being, service the public interest. The bill consolidates the enforcement of a number of Federal consumer protection laws into one Federal agency; however, it adds another layer of regulation to the accounting profession without consolidating any of our regulation.

This regulation would be costly because the assessment that would be levied by CFPA, and it will take significant time from our ability to serve our clients because we would be subject to periodic examinations by the agency. These are all costs that will ultimately be borne by our clients, the very consumers that this bill is supposed to protect. And it will do so without any commensurate benefit.

CPAs are asking for an exemption only for the customary and usual CPA services and volunteer or pro bono financial education activities. We are not asking for an exemption when CPAs are offering consumer financial products, such as a loan or investment products.

In fact, areas of potential abuse, such as refund anticipation loans, are covered by other provisions of the bill. We are encouraged by recent press reports that Chairman Frank is considering exempting professional services from the reach of the bill.

We appreciate the opportunity to testify today on the impact of the bill that will have effect on thousands of CPA firms that are small businesses and their clients, many of whom are also small business.

Chairwoman VELÁZQUEZ. Thank you Mr. Harris.

[The statement of Mr. Harris is included in the appendix.]

Chairwoman VELÁZQUEZ. Our next witness, Mr. Trevor Loy, is a venture capital investor in Santa Fe, New Mexico. Mr. Loy is testifying on behalf of the National Venture Capital Association, which represents the U.S. venture capital industry and is comprised of more than 450 member firms.

STATEMENT OF TREVOR LOY

Mr. LOY. Thank you, Chairman Velázquez, Ranking Member Graves, and members of the committee. Thank you for the opportunity to be part of this important discussion today.

I would like to begin by talking about risk and the difference between entrepreneurial risk and systemic financial risk.

Entrepreneurial risk involves making calculated and informed bets on people and innovation and is critical to building small businesses. Systemic financial risk involves a series of complex financial interdependencies between parties and counterparties operating in the public markets. The venture industry and the small business community are heavily dependent on embracing entrepreneurial risk, but we have virtually no involvement in systemic risk. Let me explain why.

The venture capital industry is simple. We invest in privately held small businesses created and run by entrepreneurs. These entrepreneurs grow the business using their own personal funds as well as the capital from ourselves and our outside investors, known as LPs or limited partners. We invest cash in these small businesses to purchase equity, i.e., stock, and we then work closely alongside the entrepreneurs on a weekly basis for 5 to 10 years until the company is sold or goes public. When the company has grown enough so that it can be sold or taken public, the VC exits our investment in the company and the proceeds are distributed back to our investors in our funds.

When we are not successful, we lose the money we invested, but that loss does not extend to anyone else beyond our investors. Even when we lose money on investments, it does not happen suddenly or unexpectedly. It takes us several years to lose money and the investors in our funds all understand that time frame and the risk when they sign up.

Debt, known as leverage, which contributed to the financial meltdown, is not part of our equation. We work simply with cash and with equity. We do not use debt to make investments or to increase the capacity of the fund. Without debt or derivatives or securitization or swaps or other complex financial instruments, we don't expose any party to losses in excess of their committed capital.

In our world, the total potential loss from a million dollar investment is limited to a million dollars. There is no multiplier effect because there are no side bets, unmonitored securities, or derivatives traded, based on our transactions. There are no counterparties tied to our investments.

Nor are venture firms interdependent with the world's financial system. We do not trade in the public markets and our investors cannot withdraw capital during the 10-year life of a fund, nor can they publicly trade their partnership interest in the fund.

The venture capital industry is also much smaller than most people realize. In 2008, U.S. venture capital funds held approximately $200 billion in aggregate assets and invested just $28 billion into start-up companies. That is less than 0.2 percent of the U.S. gross domestic product. Yet, over 40 years, this model has been a tremendous force in U.S. economic growth, building industries like biotech, semiconductor and software. Now we are increasingly helping to build renewable energy and other green-tech sectors.

Companies that were started with venture capital since 1970 today account for 12.1 million jobs and $2.9 trillion in revenues in the U.S. That is nearly 21 percent of the U.S. GDP, but it grew from our investments of less than 0.2 percent of GDP.

My main point, therefore, is that harming our industry will prevent a major part of the future American economy from growing out of businesses that are today's small businesses; and that is the risk that you should be concerned about.

Now, we do recognize the legitimate need for transparency and we simply ask that you customize the regulatory approach to fit what we do. Today, VCs already provide information to the SEC. That information, submitted on what is called Form D, should already be sufficient to determine the lack of systemic risk from venture capital firms. This filing process could easily be enhanced to include information that would provide greater comfort to our regulators. An enhanced Form D—let's call it Form D-2, could answer questions on our use of leverage, trading positions, and counterparty obligations, allowing regulators to then exempt from additional regulatory burdens firms like ours that don't engage in those activities and, therefore, don't pose systemic risks.

In contrast, formally registering as investment advisers under the current act, as the current proposals require, has significant burdens without any additional benefits. And let me be clear, registering as an advisor with the SEC is far from simple, and it is not just filling out a form. The word "registration" in that context might sound like registering your vehicle, telling the motor vehicle department what kind of car it is and who you are and where you live. It might conjure up images of things like smog checks and our proposal for the Form D-2 is equivalent to that.

But actually the word ″registration″ in the SEC context comes with a lot of other requirements. To continue my analogy with your car, it is equivalent to having to hire a full-time driver, plus a compliance officer who rides in the front seat to make sure that driver is operating the car correctly, plus a mechanic who lives at your house to fix the car and works only on your car, plus providing the government with information about every place you drive.

Moving back to the actual world of SEC registration involving examinations, complex programs overseen by a mandatory compliance officer, it will demand significant resources which promise to be costly from both a financial and human resources perspective. My own firm believes it will be one-third of our entire annual budget.

Your support has not gone unnoticed by us and we appreciate it. We cannot afford another situation where the unintended consequences of well-intentioned regulation harms small businesses and the economic growth that we drive. We look forward to working with the committee on that goal.

Chairwoman VELÁZQUEZ. Thank you, Mr. Loy.

[The statement of Mr. Loy is included in the appendix.]

Chairwoman VELÁZQUEZ. Our next witness is Mr. David Hirschmann. He is the President and CEO of the Center for Capital Markets Competitiveness in the U.S. Chamber of Commerce. The U.S. Chamber of Commerce is the world's largest business federation, representing 3 million businesses.

Welcome.

STATEMENT OF DAVID T. HIRSCHMANN

Mr. HIRSCHMANN. Thank you, Chairwoman Velázquez, Ranking Member Graves, members of the committee. I really think this is a very timely hearing.

Today, what I would like to do is talk specifically about an issue of great concern to many of our members, especially our small business members, the proposed Consumer Financial Protection Agency.

The U.S. Chamber supports the goal of enhancing consumer protection. In fact, the Capital Markets Center that I run was founded 3 years ago before the financial crisis to advocate for comprehensive reform and modernization of our regulatory structure, including strong consumer protection.

Consumers, including small businesses, need reforms that will ensure clear disclosure, better information; they need vigorous enforcement against predatory practices and other consumer frauds, and we need to close the gaps in current regulation. However, the proposed Consumer Protection Agency is the wrong way to enhance protections. It will have significant unintended consequences for consumers, small businesses, and for the overall economy.

Today, the Chamber will release a study that examines the impact of CFPA on small business access to credit. The study is authored by Thomas Durkin, an economist who spent more than 20 years at the Federal Reserve Board. My remarks draw on the findings of that study to make the following points. [The study is included in the appendix]

Small businesses, including those that we traditionally count on to be the first to add jobs in the early stages of an economic recovery, need access to credit to survive, meet expenses, and grow. Small businesses often have difficulty obtaining commercial credit and, therefore, turn to consumer credit and consumer financial products to supplement their short-term capital needs. The CFPA will reduce the availability and increase the costs of consumer credit. As users of consumer credit products, small businesses will see the same result despite being fundamentally different than the average consumer.

The proposed CFPA will likely restrict, and in many cases eliminate, small business access to credit and increase the cost of credit they would be able to obtain. This CFPA ″credit squeeze″ could result in business closures, fewer start-ups, and slower growth, ultimately costing a significant number of jobs that would be lost or simply not created.

Finally, the CFPA will only exacerbate the weaknesses of our current regulatory system without enhancing consumer protections.

In 2006, 800,000 businesses created new jobs in this country; 642,000 of them had fewer than 20 employees. Small businesses generally have trouble borrowing money. Either they can't borrow or they cannot borrow as much as they need, and almost certainly they cannot secure long-term financing available to larger companies.

To supplement the reduced access to traditional loans, small businesses rely extensively on consumer lending products, and they use them as a source of credit very differently than consumers. In other words, personal credit is the lifeline that sustains small businesses, particularly start-ups.

Many of the products that small businesses rely on may be considered to some as fringe products, but they are the very products that small business owners use to meet their short-term capital needs. As one example, auto title loans provide small business owners immediate access to cash and no upfront fees or prepayment penalties, and therefore can be useful meeting short-term business expense.

However, the CFPA in its approach failed to recognize the difference between small businesses and average consumers both in terms of need and sophistication and their appetite for risk. As proposed, the CFPA will likely reduce the availability of these products and increase their costs. It will make it harder for financial firms to meet the needs of small businesses. The CFPA will create considerable new risks to lenders in terms of regulatory fines and litigation risks from extending credit to small businesses.

H.R. 3126 is the wrong approach. It simply adds a new government agency on top of an already flawed regulatory structure.

As one example, rather than streamline consumer protections to eliminate gaps, regulatory arbitration, and create uniform national standards for key issues like disclosure, the legislation would foster a complex and confusing patchwork of 51-plus States regulation in addition to new Federal rules.

As we begin to see signs of economic recovery, we need to be especially careful to fully understand the impact of a new regulatory layer on small businesses, both as consumers and as providers of financial products. We look forward to working with the members of the committee on the modernization of our regulatory structure and appreciate your holding this hearing today.

Chairwoman VELÁZQUEZ. Thank you, Mr. Hirschmann.

[The statement of Mr. Hirschmann is included in the appendix.]

Chairwoman VELÁZQUEZ. Our next witness is Mr. Mike Anderson. He is the President of the Essential Mortgage Company in Baton Rouge, Louisiana. Mr. Anderson is a 30-year veteran in the mortgage industry. He is testifying on behalf of the National Association of Mortgage Brokers, which represents the interests of mortgage brokers and home buyers.

STATEMENT OF MIKE ANDERSON, CRMS

Mr. ANDERSON. Thank you. I have a little opening statement:

Small businesses in the financial service arena are under tremendous risk and we need your help.

Good afternoon, Chairwoman Velázquez and Ranking Member Graves and members of the committee. I am Mike Anderson. I am a Certified Residential Mortgage Specialist and Vice Chairman of the Government Affairs Committee of the National Association of Mortgage Brokers. I am also a practicing mortgage broker in the State of Louisiana, with over 30 years of experience. I would like to thank you for the opportunity to testify today.

We applaud this committee's response to the current problems in our financial markets. We share a resolute commitment to a simpler, clearer, more uniform and valid approach relative to financial products, most specifically with regard to obtaining mortgages and to protecting consumers throughout the process. NAMB has several areas of concern with the CFPA.

It is impossible to have one large agency develop and maintain comprehensive consumer protections. Consumer protection needs to exist at the State level, closer to the consumers. As proposed, the CFPA will favor big business. It will choose winners and losers, and the losers will be the small businesses and consumers.

Before I address our overall concerns, I must first extinguish the false allegations targeted at mortgage brokers for many years. First of all, brokers do not create loan products. We do not underwrite the loan or approve the borrower for the loan. We do not fund the loan. We provide consumers with an array of choices and permit them to choose the loan payments that fit their particular needs and to provide an on-time closing.

We are regulated. State-regulated mortgage brokers and lenders comply with State and Federal consumer protection laws, including State predatory lending laws. Federally chartered banks are preempted from these predatory lending laws.

And lastly, we did not receive any TARP funds.

The typical mortgage broker of today exists as an origination channel for consumers who wish to purchase or refinance their home. Mortgage brokers typically employ anywhere from 2 to 50 people, and they serve communities big and small, urban and rural in all 50 States, truly classifying them as a valuable small business entity.

In order for the CFPA to be effective, it must act prudently when promulgating and enforcing rules to ensure that real protections are afforded to consumers and not merely provide the illusion of protection that comes from incomplete or unequal regulation of similar products services or providers, whereas financial reform is to provide transparency, clarity, simplicity, accountability, and access in the market for consumer financial products and to ensure the markets operate fairly and efficiently.

It is imperative that the creation of new disclosures or the revision of the antiquated disclosures be achieved through an effective and even-handed approach and consumer testing. It is not the who, but the what that must be addressed to ensure true consumer protection and success with this initiative.

There should be no exemptions from consumer protections whether the CFPA is created or not. The Federal Government should not—and I repeat, should not—pick winners and losers, which is where we believe the Federal reform is heading.

We are very supportive of the concepts of the proposed single, integrated model disclosure for mortgage transactions that combine those currently under TILA and RESPA. Consumers will greatly benefit from a uniform disclosure that clearly and simply explains critical loan terms and costs.

Therefore, NAMB strongly encourages this committee to consider imposing a moratorium on the implementation of any new regulations or disclosures issued by HUD and the Federal Reserve Board for at least a year until financial modernization has become law. This will help to avoid consumer confusion and minimize the increased cost and the unnecessary burden borne by industry participants to manage and administer multiple significant changes to the mandatory disclosures over a short period of time.

NAMB strongly supports the concept of mandating a comprehensive review of the new and existing regulations, including the Home Value Code of Conduct, the HVCC. Too often in the wake of our current official crisis we have seen new rules promulgated that do not effect measured balance and effective solutions to the problems facing our markets and consumers—

Chairwoman VELÁZQUEZ. Mr. Anderson, time has expired. You will have an opportunity during the question-and-answer period.

Mr. ANDERSON. Thank you.

[The statement of Mr. Anderson is included in the appendix.]

Chairwoman VELÁZQUEZ. Our next witness is Mr. J. Douglas Robinson. He is the Chairman and CEO of Utica National Insurance Group in New Hartford, New York. Utica National is among the top 100 property casualty insurance organizations in the country. He is testifying on behalf of the Property Casualty Insurers of American, which has over 1,000 members.

STATEMENT OF J. DOUGLAS ROBINSON

Mr. ROBINSON. Chairwoman Velázquez, Ranking Member Graves, and members of the committee, thank you for the opportunity to testify.

I am J. Douglas Robinson, Chairman and Chief Executive Officer of the Utica National Insurance Group, a group led by two mutual insurers headquartered near Utica, New York. Utica National provides coverages primarily for individual and commercial risks with an emphasis on specialized markets, including public and private schools, religious institutions, small contractors, and printers.

My company markets its products through approximately 1,200 independent agents and brokers. Our 2008 direct written premiums were more than $632 million. I am testifying today on behalf of the Property Casualty Insurers Association of America, which represents more than 1,000 U.S. insurers.

We commend President Obama and Congress for working to ensure that the financial crisis we experienced last fall is never repeated. Achieving this goal requires a focus on fixing what went wrong with Wall Street without imposing substantial new one-size-fits-all regulatory burdens on Main Street, small businesses, and activities that are not highly leveraged nor systemically risky.

My company insures small businesses like bakeries, child care centers, auto service centers, and funeral homes. These Main Street businesses should not bear the burden of an economic crisis they did not create. Home, auto, and commercial insurers did not cause the financial crisis, are not systemically risky and have strong and effective solvency and consumer protection regulation at the State level. We are predominantly a Main Street, not a Wall Street, industry with less concentration and more small business competition than other sectors.

Property casualty insurers have not asked for government handouts. Our industry is stable and continues to provide critical services to local economies and communities.

However, small insurers are concerned about being subject to administration proposals intended to address risky Wall Street banks and securities firms, but that apply broadly to the entire financial industry.

Specifically, we are concerned about the following:

The proposed Consumer Financial Protection Agency does not adequately exclude insurance from its scope. An exclusion should be added for credit, title, and mortgage insurance, which are generally provided by and to relatively small businesses. Protection should be added for insurance payment plans which are already well regulated by State insurance departments.

The proposed new Office of National Insurance is given too much subpoena and preemption power without adequate due process or limits on its scope and its ability to enter into international insurance agreements. It also needs a definition of ″small insurer″ to prevent excessive reporting requirements.

Systemic risk regulation needs to be modified to reduce government backing of large firms at the competitive expense of small financial providers. Leveraged Wall Street behemoths must not be made bigger through government bailouts and consolidation. Government shouldn't forget or harm Main Street in addressing systemic risk regulation.

Resolution costs of systemically risky firms should be paid for by firms with the greatest systemic risk. Bank regulators should not be allowed to resolve systemic risk failures by reaching into the assets of small insurance affiliates whose losses would then be charged to other innocent small competitors through State guaranty funds.

Finally, congressionally proposed repeal of the McCarran-Ferguson Act would significantly reduce insurance competition, primarily harming smaller insurers that would not otherwise have access to loss data and uniform policy forms necessary to compete effectively, and that would ultimately harm consumers.

The cost of new regulations almost always disproportionately affects small business who can least afford the necessary legal and compliance requirements. The property casualty industry is healthy and competitive and the current system of regulating the industry at the State level is working well. Should the Congress fail to address the issues we have identified, the consequences on consumers and the economy could be quite harsh, imposing an especially large burden on small insurers and small businesses.

Thank you.

Chairwoman VELÁZQUEZ. Thank you, Mr. Robinson.

[The statement of Mr. Robinson is included in the appendix.]

Chairwoman VELÁZQUEZ. And we have four votes right now, so the committee will stand in recess for approximately 30 minutes and will reconvene right after.

[Recess.]

Chairwoman VELÁZQUEZ. The committee is called to order.

I want to address my first question to Mr. Hirschmann, Mr. Harris, and Mr. Anderson.

In determining the impact of a new consumer protection authority, structure and details are key. For example, the manner in which the term "credit provider" is defined will be especially critical.

So how can Congress define these terms in a way that minimizes the impact for small businesses?

Mr. Hirschmann?

Mr. HIRSCHMANN. I think you are exactly right. Both the scope of the bill, as originally drafted—and we recognize that Chairman Frank has indicated that he is working on that issue—as well as the terms. Many of the key terms were so ill defined and the powers that were granted to the proposed agency are so significant that it really leaves that up to the new regulator to decide; and we can't afford to do that.

So I don't have an answer for you on how to specifically define credit, but clearly you need to target it to the specific firms that are providing direct credit and not indirectly to those who are providing material support or indirectly the way the original bill contemplated.

Chairwoman VELÁZQUEZ. Mr. Harris.

Mr. HARRIS. I would concur with that.

We were providing a service or even those who are providing a trade or business that is not just purely loaning of money is where we would get into it. I mean, I cannot think of one client I have—virtually, other than a restaurant—that would not be one who does not provide credit of some sort. A doctor's office—and doctors' offices even for people who are on Medicare, you have copays; and the copays are billed to those people after they have seen the doctor. So then the doctors have substantial accounts receivable.

Are they credit providers? I don't think that was ever the intent.

Chairwoman VELÁZQUEZ. Mr. Anderson?

Mr. ANDERSON. I guess we really have to define who is the creditor on behalf of the mortgage brokers. I mean, we are truly not the creditor, and yet we do perform a function, taking loan applications from applicants and explaining loan terms and giving them disclosures.

So until we define who really is the creditor, that is all I can answer on that.

Chairwoman VELÁZQUEZ. Mr. Hirschmann, Mr. Harris, the financial crisis wreaked havoc on consumers. We all know that. And to that end, several Members of the House, including Representative Minnick, are proposing an alternative consumer protection council, one that will coordinate regulatory actions across several State jurisdictions.

What is your take on this idea?

Mr. HIRSCHMANN. We have not yet seen the details, but we do think that consumer protection should be an important part of the overall regulatory reform; and so we welcome alternatives, particularly alternatives that build on the current structure that requires better coordination among existing regulators, that provide for better disclosure to consumers and tougher enforcement against predatory practices.

Mr. HARRIS. I think AICPA would concur with that. We are talking about in our area—of course, we believe that products should be in and certain services should be out.

Chairwoman VELÁZQUEZ. Mr. Loy, in your testimony you touch on the distinction between hedge funds and venture capitalists. Given the role that hedge funds play in this debate, can you elaborate on that distinction and talk about differences about how VCs and hedge funds should be regulated?

Mr. LOY. Thank you. So I think I would begin by saying it is easier to define it by what is similar. There is really only one similarity between a hedge fund and a venture capital fund, and that is the legal structure that we use. We typically are organized as limited partnerships and they are typically organized as limited partnerships and the investors become the limited partners.

Beyond that, hedge funds are associated with trading in the public markets. They typically—in addition to the capital that investors put into the hedge fund, they borrow, in other words, they use leverage, several multiples of that capital that the investors have put in, to make a broader set of investments.

They often invest for fairly short periods of time, and I know that can range based on their strategy. But it can be as short as a few hours, typically in the days or weeks; some hedge funds may be for a few months. And so they are also bringing the capital in up front from the investors and the investors have the ability typically to pull their money in and out.

And then, lastly, a lot of hedge funds particularly trade in these off-balance-sheet securities, derivatives.

Beyond that, I would be clear to say that I not an expert on hedge funds, so I am not going to comment on how they should be or should not be regulated.

But what I will comment on is for venture capitalists. We use the same legal structure, but the similarities end there. Our investors put money in as limited partners, but do not have the ability to take money out for 10 years. We do not use leverage at all, so the money that investors put in our fund in cash is the money that we have available.

On top of that we invest only in stock, not in credit. We expect each investment we make to hold that investment for 5 to 10 years. And the last difference is that we work very closely operationally with the businesses, the small businesses, to help them grow. Hedge funds, I think, more typically have a distance between them in that regard.

So all I can say is that the current advisor act in the contemplated regulations for hedge funds are clearly designed for hedge funds and, for example, require a compliance officer in a firm to report periodically on the public market trading positions of that hedge fund.

If we were to be—right now we are encompassed in the same regulation—we would similarly be required to hire a chief compliance officer to tell the SEC about our public market trading positions, even though our fund agreements do not even allow us to trade in the public market. So this very expensive person would sit there and fill out a form that said zero or N/A every month.

Chairwoman VELÁZQUEZ. But in the sense that hedge funds borrow big money and try to exploit inefficiencies in the market, wouldn't you say that there is an element of risk that we don't see in venture capitalists?

Mr. LOY. Again, I would rather comment on the venture capital piece.

Chairwoman VELÁZQUEZ. Can we touch on the private equity firms?

Mr. LOY. Sure.

Chairwoman VELÁZQUEZ. They are another unique financial entity. Do you have any position as to how they should be regulated?

Mr. LOY. I don't. I think that that is up to the expertise of the people on this and other committees.

I do think that there are substantial differences in the types of investing and the types of leverage that they use. Again, they use the same legal structure as us, but there are significant differences beyond that.

Chairwoman VELÁZQUEZ. Thanks.

Mr. Harris, in your testimony, you said that CPAs should be—should not be exempt from activities that are not customary and usual. And the vagueness of the phrase "not customary and usual" could create the exact kind of problems that you are seeking to avoid.

How do you recommend that legislators implement this distinction?

Mr. HARRIS. CPAs have a very close relationship with their clients, and there are a lot of questions that go back and forth on a routine basis. And so many of these are small clients and they rely upon us for all kinds of advice, both tax advice for the company and the individual.

When I am talking with a doctor who happens to be set up in a form—an entity which is a partnership or a PA, I can't help but talk to him about both at the same time. That is where our biggest problem is.

Where we believe that CPAs should come under the act would be when they are involved in selling some form of a product. So, for instance, my client comes to me and says, I need some help. We say we believe you need a loan and we recommend that you go to the bank and talk to the bank. That would be exempt.

However, if we said, But by the way, we will make you that loan, in that case we should come under the act, where there is a product involved.

Chairwoman VELÁZQUEZ. Can we use like the example of H&R Block?

Mr. HARRIS. Who are not CPAs? Yes.

Chairwoman VELÁZQUEZ. But they do accounting. And also they make refund anticipation loans. So that part should be regulated.

Mr. HARRIS. We totally agree with that, and if there is a CPA doing that, we believe that is a product and, in fact, should be regulated.

Chairwoman VELÁZQUEZ. Mr. Graves.

Mr. GRAVES. In all the debate, when it came to the bailouts and everything that took place, we had a lot of talk about financial institutions being too big to fail. And my question to each of you is there—in our capitalist society, such a thing as an institution that is too big to fail? And if one of the very large financial institutions did fail, how would that affect you or your business or your clients, whatever the case may be?

Mr. Harris?

Mr. HARRIS. I have listened quite a bit to Mr. Geithner and Mr. Bernanke on that issue, and I happen to concur with them. There are some institutions which are too big to fail and would have brought the world financial markets to a standstill if they did.

I also understand what happened with those that did fail and what their limitations were at time. It would have a tremendous effect—it is already having a tremendous effect, because right now most small businesses are having a difficult time borrowing money with the same entities that did not fail. But because they are having to go from a leveraged model to a much lower leveraged model than they were practicing—and those are major banks that we all know that are still here today, that may be owned by someone else.

I can give a perfect example of a public hospital that I sit on the board of; and we were forced to liquidate our endowment fund to pay off our bonds because we couldn't get the line of credit to secure those bonds that we could always get with no problem. We had the money to do it, but it will put the hospital in a very tenuous situation in the event we continue to lose money because of Medicare cuts. And I happen to live in an area which is a very high Medicare area.

So it is already having that effect. I can tell you it has had that effect just on what has occurred to small business. Lines of credit and letters of credit are virtually impossible to get for small business.

Mr. GRAVES. Mr. Loy?

Mr. LOY. What I would say we do: We invest in companies that often don't exist; we help them start.

We have been using a phrase of "too small to fail." These are the companies that, a very small proportion of which are going to grow up to be the next Google, Cisco, Apple, Genentech, FedEx, Starbucks, et cetera. And we are concerned about the opposite problem, which is the situation where we are creating a problem, where it is too hard for those companies to get really big, particularly on the IPO side, so they are choosing to sell out early in order to get some money back to the investors.

And typically when other companies are acquired by companies—including, increasingly, overseas companies—they are not going to grow up to be the drivers of 12.1 million jobs that represent the last 20 years of venture investing.

In terms of the impact of the Lehman-led crisis or another one—Mr. Harris' example is actually an interesting one; he mentioned that in order to get liquidity for their bond fund, they had to liquidate their endowment—the largest source of capital for our industry is actually endowments and foundations and pension funds; and we have seen a dramatic drop in their willingness or ability to provide capital to our industry because they are repurposing it away from higher risk, higher reward, but highly illiquid and long-term investments to short-term liquidity needs.

I would characterize it as much as a timing problem at any moment in time. The capacity and willingness to fund things for 5 or 10 years, while they grow up to be the next generation drivers of job creation, are seriously at risk. Even as it is, adding more burdens onto us is sort of why we are particularly concerned at this critical moment.

Mr. HIRSCHMANN. The right to fail in an orderly fashion has been one of the key strengths of our economy. Obviously, when everything fails at one time, it requires extraordinary steps.

But I think one of the things we need to be careful about is not to design our system so that there is an implied backstop by the Federal Government against the two largest mutual fund companies, the two largest hedge funds, the two largest private equity firms, or the two largest of anything. We need to be able to have the information at the regulator level to understand systemic risk, but not set anybody up to be permanently protected against failure.

We can make them fail in a more orderly fashion so they don't burn down the neighborhood, but nobody should be insulated against failure.

Mr. ANDERSON. I love your question.

I don't know if you saw the Wall Street Journal a couple of days ago where it shows that 52 percent of all loan originations and closings happen by the top three companies, where if you look at that 2 years ago, one of them was down to like 4 percent. That is dangerous. That is why I said in my opening remarks that the small businesses are at risk.

Do we want loan origination for home mortgages to be controlled by three companies in America? There have been an awful lot of choices for mortgages—a lot of small mortgage bankers who have done a phenomenal job, who never ever participated in the subprime or pay option ARMs that got us in this mess to begin with. But a lot of these small companies can't get warehouse lines of credit.

We did a very good job. My company, personally, we had the second lowest FHA delinquencies in the State of Louisiana, and we are at risk. So is a company too big to fail? I don't think so.

Mr. ROBINSON. Congressman, it is hard to come up with the number as to how large is a company that is too big to fail. I think more important is, how much it is leveraged, how interconnected it is; and in our business, how you manage your accumulations or how much stuff do you have out there that could cause a problem.

For example, as far as leveraging goes, our company is a mutual company. The only way we can raise capital is through operations. We do not issue stock. In our business, one of the leverage measures is premium-to-capital or premium-to-surplus, which is a proxy for how many policies you write and how much exposure you have.

In our business three-to-one, three times your capital, is probably the upper limit. Two-to-one is much better. My company is one-to-one because we are pretty conservative. I am told some banks get up to 30-to-1. The question really is, what is your leverage ratio? I think that is one point that is more important than absolute size.

Another question is how interconnected you are. What is the counterpart of your risk if either the counterpart or yourself has a problem?

In our industry rarely reinsure one another. When we buy reinsurance, kind of like laying off a bet, we go to the worldwide market. So there is not much interconnectivity in our industry, but it is something I believe you can measure.

And finally, there is what we call "accumulations". That is, how many houses do you insure on the beach and how many businesses on an earthquake fault line and so on. You need to be able to measure precisely that and report that to regulators to make sure that you haven't overextended yourself.

I think if you look at those three items instead of absolute size, you could come up with a much better result.

Mr. GRAVES. Thank you, Madam Chair.

Chairwoman VELÁZQUEZ. Mrs. Dahlkemper.

Mrs. DAHLKEMPER. Thank you, Chairwoman Velázquez and Ranking Member Graves for convening this critical hearing on the impact of financial and regulatory restructuring on small businesses and community lenders. And thank you to the panel of witnesses for joining us today.

While it is clear from the recent economic crisis that we must impose greater oversight, transparency and accountability in the financial sector, we must also ensure that our financial regulatory restructuring does not negatively impact the ability of financial institutions to continue to provide the American people, our small businesses and our communities with access to capital. Ensuring liquidity in the market will continue to promote economic recovery.

In my district in Pennsylvania, local businesses are reeling as a result of banks not lending. So we have to enact balanced reform, but still allow for a healthy flow of capital. However, we must also ensure that consumers are protected and adequately informed in their financial choices and that they are ensured a variety of financial products that carry better disclosed and understood risk.

Mr. Anderson, I do have a couple questions for you. In your testimony, you mentioned a host of Federal regulations that mortgage brokers must comply with.

Which Federal agencies are charged with enforcing these regulations?

Mr. ANDERSON. Well, we have got RESPA; that is number one, under HUD.

We have the Truth in Lending Act. I mean that has to do with your disclosures, your good faith and truth in lending. All of this, mortgage brokers, banks savings and loans, we all operate under that umbrella.

Also in our States, individual States, we have to adhere to the same policies; and some of our States have predatory lending laws. In Louisiana, we just passed a law that there are no prepayment penalties, which is a good thing.

So we are all under the same umbrella, and we have to comply with our own State lending laws. And we have got the Safe Licensing Act, which is for everybody.

Mrs. DAHLKEMPER. Let me ask you, because there are a number of agencies: Do you think it would be better, in your view, to combine enforcement under one agency or entity, rather than having to deal with a number of different agencies?

Mr. ANDERSON. I don't know if that is going to create a bottleneck. I am not sure.

We feel that we need to slow down, maybe look at this further. We are all for—the National Association of Mortgage Brokers is all for simpler, easier disclosures. I think if we look at what happened in the past with the subprime and all of those other loans, I think we—I relate it to the pharmaceutical industry.

If you take Vioxx, what happened to Vioxx? It was banned. We didn't go after the pharmacists or the drugstores on the corner. We went after the manufacturer. And I think if we control the manufacturer, that is, the product—if the product caused the foreclosure crisis, we need to eliminate that product.

Mrs. DAHLKEMPER. Let me ask you then a question that goes along with that, because it has been reported that mortgage brokers who processed the subprime loans are now counseling individuals who are indebted by those loans regarding their restructuring.

So does your association promote standards by which brokers evaluate the financial suitability of loan products by prospective borrowers? Or do you just rely upon the lenders, underwriters for that?

Mr. ANDERSON. Well, the way the National Association of Mortgage Brokers operates, we have a very strong code of ethics. We do not have a fiduciary responsibility to the borrowers. We counsel the borrowers. We do not underwrite the loans.

And I will give a prime example where the mortgage broker got blamed, and that was with Fannie Mae and Freddie Mac. And we know what happened there. I can tell you, I have done a lot of loans, and Fannie Mae and Freddie Mac had an automated underwriting system and they would approve borrowers at 100 percent financing with a 65 percent debt-to-income ratio before taxes.

Now, can the mortgage broker turn that borrower down when it was approved by Fannie Mae and Freddie Mac? If we did take that approach, if I would turn somebody down for that, I could be sued because—for discrimination or what have you. And those are the mistakes that happened.

Mrs. DAHLKEMPER. So what is your role then in this?

Mr. ANDERSON. The role of a mortgage broker is to offer the products, just like an insurance broker.

Why do you go do a insurance broker? Because they represent a whole host of carriers. The mortgage broker does the same thing; we represent a whole host of carriers of lenders and banks across the country. We service a lot of small, rural areas. And the mortgage broker has done a phenomenal job. There is equal blame across the board for banks, mortgage brokers—

Mrs. DAHLKEMPER. So you don't have any financial stability standards that you, as an association, apply?

Mr. ANDERSON. I mean, we have a strong code of ethics.

Mrs. DAHLKEMPER. Thank you.

My time is up. I yield back.

Chairwoman VELÁZQUEZ. Would the gentlewoman yield?

Mrs. DAHLKEMPER. Yes.

Chairwoman VELÁZQUEZ. Mr. Harris, if you provided bad advice to a customer or client, would you be liable?

Mr. HARRIS. Oh, yes.

Chairwoman VELÁZQUEZ. Mr. Anderson, if you sell a product that is inappropriate, that is not a good product, are you liable?

Mr. ANDERSON. That is a hard question. I mean—

Chairwoman VELÁZQUEZ. My guess is that that is the core of her question when she asked "regulators."

There is not such a regulator who would come in and examine and do any regulating examination of your activities?

Mr. ANDERSON. No. We are regulated. We are examined; on a State level, we are examined.

Chairwoman VELÁZQUEZ. We are talking about the Federal Government and Federal legislation that is pending before—that is being considered now, that is being worked by Chairman Frank.

So the question is consolidating Federal regulation so that it has uniformity with the mortgage brokers industry.

Mr. HARRIS. Madam Chairwoman, if I could also comment because I answered you with a very simple answer when I said, "Oh, yes."

Not only to our client, but if we provide bad tax advice and in the end, as the result of an IRS audit, the IRS can and will fine us significantly. We also face criminal penalties from the IRS.

Chairwoman VELÁZQUEZ. Okay.

Mr. Westmoreland.

Mr. WESTMORELAND. Thank you, and I want to thank the Chairlady for having this hearing. I—this is my third term in Congress, and I want to congratulate her in having this, because this is the first hearing we have had, I think—at least that I have been associated with in my committees—that really we get to hear the unintended consequences of what a proposed piece of legislation can bring into different entities that are so important to our economy.

So I want to thank her for doing that, because unintended consequences are things that happen when we pass legislation hastily up here.

Mr. Anderson, I want to say that I know that the mortgage brokers—I come from a real estate background, the building business—that you all were very big proponents of the SAFE Act that was passed in 2008 that basically licensed brokers, mortgage brokers, which had not been the case. So you have been a proponent of regulation that you thought was necessary for your industry.

But we see unintended consequences all the time up here. The credit card act that we passed with the consumer protection stuff in there, there has been an unintended consequence that people that actually really need a credit card and actually need some short-term credit are not able to get it.

And when we passed some housing legislation—and, Mr. Anderson, I will address this to you—I think it has some unintended consequences. And, sure, we made bad loans and we had all different types—as Mr. Loy said, derivatives. We were selling programs that nobody even knew what they were. They just knew they were making a bunch of money doing it.

But right now, if I understand it correctly from some of my friends still in the real estate business and still in the mortgage business, there are some loans in some States that you can't even offer people. Because of some of the regulations that have been put on as far as what credit scores are, additional points and fees that are added to these things, that came from some of the regulation that we passed trying to help the situation, have actually hindered it.

Can you comment on that?

Mr. ANDERSON. Yes, we have—if I can use the term, ″we have had our hands tied.″ And there are many, many States out there, and we are one of them, that we enjoyed a very low foreclosure rate. And the restrictions, I will tell you that there is no question—my firm is also part of the largest real estate firm in the Gulf south, and I will tell you that there is no question that the pendulum has swung so far this way now that the credit is tightening, we depleting the pool of eligible borrowers to buy these properties, and we have got to be careful. We have got to, somehow, come back in the middle somewhere.

We know the subprime loans were bad, and you are right. People made an awful lot of money from Wall Street on down. There is no question, plenty of blame to go around.

But get back to the safe mortgage product, but the credit score restrictions; and I tell you all, of all the loans that have a done in my 31-year career, if anyone can tell me the difference between a 619 and a 620 credit score, I would like to know what that is. Or a 679 and a 680. The difference is nothing on the credit.

The difference is, one borrower is going to pay an extra 1.5 to 2 points; and on an investment property—and I see it every day, every day, somebody with an 832 credit score putting 20 percent down can't get a mortgage. That is pretty sad.

Mr. WESTMORELAND. And Mr. Anderson, with the little bit of time that I have left, I know that some of our returning veterans who have been in theater and fought and defended our country, a lot of times our National Guard members and Reserve officers leave great paying jobs to go serve our country. And when they come back, sometimes their credit score has been hurt, or the spouse maybe has done something.

I understand that some of these restrictions are making it harder and harder for our military to be able to get it. Because if I understand it correctly from some of the news today, some of these credit scores are being lowered 10, 20, 30, 40, even 50 points, without anyone knowing it, just because of the reduction in the credit market.

Mr. ANDERSON. You are absolutely right.

Guys, I have seen credit scores drop 30, 40 points—and I am not kidding you—for a $12 medical collection that they had no idea that they had. I mean, it is amazing. We are just set on this number of a credit score.

There are so many factors that you have to look at. I mean, it seems like we are going back 20 or 30 years which—there is nothing wrong with that concept, but people have to qualify. But just using a number and a credit score, that is creating some problems.

Mr. WESTMORELAND. Thank you, Madam Chair.

Chairwoman VELÁZQUEZ. Thank you.

Mr. Luetkemeyer.

Mr. LUETKEMEYER. Thank you, Madam Chair. You know, it seems as though the approach that the Financial Services Committee is taking is that we have got a problem out here, and/or they think they have got a problem, and we are going to use a big patch on it. And it seems like having a sprained ankle and cut the leg off to solve our problem.

I think sometimes when we have a problem, we have to see what the problem is and then go back and fix that problem and not have the unintended consequence, what Congressman Westmoreland was talking about.

Too often it appears to me in this situation that this piece of legislation is so broad it is going to provide an umbrella over anything when anybody has any sort of a monetary transaction. I think you gentleman have helped to define where we ought to be going this, and it is the big guys that have stumbled along and not done things the way they should have; and a lot of other folks are being caught in this net.

So I guess my comment is, have I identified this correctly? Do you think basically we need to be looking at the too-big-to-fail-guys that really were—the problem seems to originate from? Are there some small players in this that have got enough blame to go around, and we can play with them too?

Mr. Robinson?

I don't think you guys had any problems. We only had one insurance company, and that was the investment portion of that that was the problem versus the insurance company; is that right?

Mr. ROBINSON. That is correct, Congressman.

If there is a common thread that I could recommend that might answer some of these questions, it is, how broad a measure would be needed to cover all kinds of problems. It is answering a simple question like, Who underwrites the risk and who prices it? Because you could have somebody saying, Well, I thought the loan originator was. Well, I thought they were.

Well, who is? Whether it is a credit default swap or a mortgage.

And I think as we try to solve these issues—and there is no question that there are issues to be solved—that instead of perhaps picking a number to define too-big-to-fail, say, All right, you are big; what are your exposures and how much capital do you have to handle what statisticians would call the tail events—things that you don't think happen?

And if they cannot answer those questions clearly and they perhaps have no idea, then that might aim you towards the real root cause of the issue. And that might be a good step, I would recommend.

Mr. LUETKEMEYER. Okay.

Mr. HIRSCHMANN. I think you are right to identify the scope of the proposed CFPA as one of the problems.

There are a couple of other issues, including, it separates out consumer protection from safety and soundness regulation. So you might have one regulator telling you to go left and the other telling you to go right with no way to reconcile the differences. That clearly will impact the availability of credit, particularly for small firms.

The other is the ill definition of all the terms. For example, it sets up a new, vaguely defined abuse standard. What our study reveals is that a product that might seem to be abusive for one individual consumer in a particular financial condition might be the lifeline for a small business to meet their payroll that week and perfectly appropriate for the small business.

It is hard to imagine how a Federal regulator could anticipate those differences and make sure we don't accidentally cut off the vital lifeline for small businesses.

Mr. LUETKEMEYER. My time is going to run out here. Quickly, with Mr. Hirschmann and Mr. Loy and Mr. Harris, quick answers. I know we are going to have some bankers in the next section.

I was curious about access to credit. I think that really impacts small businesses in small communities and suburbs of our cities.

Have you had any comments or problems with some of the members of Chambers of Commerce with regard to access to credit that you would like to comment on—particular industries, in particular?

Mr. HIRSCHMANN. Access to credit is a significantly enhanced problem in this crisis. What our study finds is that even before the crisis, half of the smallest firms had access-to-credit problems. It is clearly magnified.

I don't know whether you point—obviously, you don't want banks to make loans that are being given to inadequate—people that don't have adequate credit.

On the other hand, you want to make sure that the small businesses have credit. That is why this secondary credit market, the ability of small firms to rely on their personal credit, especially when they are starting a business, is vital to start-ups and vital to creating new jobs in this country.

Mr. LOY. I would agree, with a caveat.

Most of the businesses that we fund are so raw, they are pure garage start-ups, they are not eligible for credit. So we don't use credit, or companies don't, until they have grown into larger entities. And it is at that stage where, historically, we have been able to bring in credit provider to scale the job creation.

That now is not happening, so we are having to supply more and more equity to later-stage start-ups, and that is causing us to not have as much ability to invest in the brand-new things. There is a falloff in seed-stage company creation because the capital that we have, that was supposed to be for that, is filling the role that debt used to play for our larger companies.

Chairwoman VELÁZQUEZ. Time has expired.

Ms. Fallin.

Ms. FALLIN. Thank you, Madam Chair. I am sorry I couldn't be here for all the hearing, but what I have heard is very interesting; and I will talk about what I am hearing in my home State of Oklahoma.

I am hearing from businesses that lines of credit are hard to come by, that they are seeing sometimes double-increased rates on their interest rates. I am hearing that their lines of credit have been, many times, cut in half to where they do not have the lines of credit. And I am hearing from some of our business owners that when they do want to take equity out of their businesses, they can't take it out of their businesses to expand their product.

My question would be, what has changed over the last 2 to 3 years that has caused this market to tighten up? And what are the problems associated that have caused those things?

And in this new Consumer Financial Protection Act, do you think that will help the situation where more money will be available and the credit will start flowing? Or are we reaching too far, and it is going to cause the market to contract?

Mr. HARRIS. I will say that it is very hard—I refer to smaller businesses and some are public institutions—hospitals, private schools—who are suffering because they can't get their loans.

The problem is—the community banks are wonderful, and they serve a tremendous need for smaller clients, and they have come through for the clients and the small businesses. The community banks have been very good.

The problem we see in that area is when you get to $2 and $3 or $4 and $15 or $18 million, which are still small entities in small towns, who have these kinds of lines of credit or letters of credit to secure bonds, public bonds that have been issued. The big banks are the ones who can no longer make those loans, and as a result—we are seeing in a number of private institutions—they are having to try to figure out a way to pay off the bonds with far more expensive capital. And it is not a positive thing; it is not good for them.

And what you are hearing at your home is the same as I am hearing all across the country.

Mr. LOY. I was just in Oklahoma last week for 3 days looking at seed-stage start-ups to invest in, coming out of your research universities. Some really exciting things, particularly in the energy arena.

Ms. FALLIN. I hope you put the money there.

Mr. LOY. We are looking and we want to, precisely for that reason. We don't provide credit; we provide investment equity capital. But because these start-ups cannot get a home equity loan to finance their start-up, they are needing $500,000 from us; and it is getting harder and harder for us to provide that for the reasons I just said.

And the potential for this regulation would be disproportionately felt on the smallest firms that provide that earliest stage of capital. So there is a good chance that entire swath of $500,000 to $1 million of seed-stage capital, if we are forced to follow hedge funds regulation, the cost of that will drive the firms who do that out of business.

Ms. FALLIN. Can I ask, also, another question?

I am hearing from our local bankers that the fee increases to recapitalize FDIC is causing them not to have as much capital and loans to put out into the marketplace. And they have told me, like in my State, that $37 million has gone out in fee increases which they could be lending out to our small businesses and even to those who are wanting to have mortgages. And they are concerned about another fee increase on those small bankers that will once again drive capital and take it out of the marketplace.

Are you seeing that back in your individual organizations and States, that it is taking the capital out of the marketplace, lending ability?

Mr. HIRSCHMANN. It is certainly something we hear from our small banking members.

If you go to any local Chamber across the country, you will find a small banker on the board, and it is particularly one—so whether those fees are necessary, clearly you have to keep FDIC moving.

We are going through a very exigent period here. The real question is, do you want to add fees on top of that even further through the Consumer Financial Protection Agency? It is clearly the wrong time to add unnecessary fees, particularly when they won't produce the intended result.

Mr. ROBINSON. Congresswoman, perhaps there is a parallel in the financial services—noninsurance financial service area you that might consider.

I mentioned earlier about underwriting, or identifying the risk, underwriting it and pricing it properly. And you do the best job you can, whether it be a house on a beach or a subprime mortgage or whatever. And then, when the hurricane comes or the collapse happens, management meetings happen that say, We are not going to do that again.

And then we have to recast our expectations, and that usually results in underwriting tightening up, which could mean change in credit score or unwillingness to put out lines of credit.

Also, a bad result could result in an organization being overleveraged. We have too much out there and so we have to pull back.

Ms. FALLIN. Thank you, Madam Chairwoman.

Chairwoman VELÁZQUEZ. With that, let me take this opportunity to thank all of you for participating. You have given very insightful information. The members of the panel are excused.

And I will ask the members of the second panel to please come forward and take your seats. Thanks.

Chairwoman VELÁZQUEZ. Our first witness is Mr. James D. MacPhee, the CEO of Kalamazoo County State Bank in Schoolcraft, Michigan, founded in 1908. Mr. MacPhee is testifying on behalf of the Independent Community Bankers of America. ICBA represents 5,000 community banks of all sizes and charter types throughout the United States.

Thank you. You will have 5 minutes.

STATEMENT OF JAMES D. MacPHEE

Mr. MACPHEE. Thank you, Chairman Velázquez and Ranking Member Graves. I am pleased to represent the 5,000 members of the Independent Community Bankers of America at this timely and important hearing.

Just over one year ago, due to the failure of some of the Nation's largest firms to manage their high-risk activities, key elements of the Nation's financial system nearly collapsed. Community banks and small businesses, the cornerstone of our local economies, have suffered as a result of the financial crisis and the recession sparked by megabanks and unregulated financial players.

In my State of Michigan, we face the Nation's highest unemployment rate of 15.2 percent. Yet community banks like mine stick to commonsense lending and serve our customers and communities in good times and bad.

The bank has survived the Depression and many recessions in our more than 100-year history, and it proudly serves the community through the financial crisis today—without TARP money, I might add.

The financial crisis, as you know, was not caused by well-capitalized, highly regulated commonsense community banks. Community banks are relationship lenders and do the right thing by their customers. Therefore, financial reform must first do no harm to the reputable actors like community banks and job-creating small businesses.

For their size, community banks are enormous small business lenders. While community banks represent about 12 percent of all bank assets, they make 31 percent of the small business loans less than $1 million. Notably half of all small business loans under $100,000 are made by community banks.

While many megabanks have pulled in their lending and credit, the Nation's community banks are lending leaders. According to an ICBA analysis of the FDIC's second quarter banking data, community banks with less that $1 billion in assets were the only segment of the industry to show growth in net loans and leases.

The financial crisis was driven by the anti-free-market logic of allowing a few large firms to concentrate unprecedented levels of our Nation's financial assets, and they became too big to fail. Unfortunately, a year after the credit crisis was sparked, too-big-to-fail institutions have gotten even bigger. Today, just four megafirms control nearly half of the Nation's financial assets. This is a recipe for a future disaster.

Too-big-to-fail remains a cancer on our financial system. We must take measures to end too-big-to-fail by establishing a mechanism to declare an institution in default and appoint a conservator or receiver that can unwind the firm in an orderly manner. The only way to truly protect consumers, small businesses, our financial system, and the economy is to enact a solution to end too-big-to-fail.

To further protect taxpayers, financial reform should also place a systemic risk premium on large, complex financial firms that have the potential of posing a systemic risk. All FDIC-insured affiliates of large, complex financial firms should pay a systemic risk premium to the FDIC to compensate for the increased risk they pose.

ICBA strongly supports the Bank Accountability and Risk Assessment Act of 2009, introduced by Representative Gutierrez. In addition to a systemic risk premium, the legislation would create a system for setting rates for all FDIC-insured institutions that is more sensitive to risk than the current system and would strengthen the deposit insurance fund.

ICBA strongly opposes reform that will result in a single Federal bank regulatory agency. A diverse and competitive financial system with regulatory checks and balances will best serve the needs of small business.

Community bankers agree that consumer protection is the cornerstone of or financial system. However, ICBA has significant concerns with the proposed Consumer Financial Protection Agency. Such a far-reaching expansion of government can do more harm than good by unduly burdening our Nation's community bankers, who did not engage in the deceptive practices targeted by the proposal. It could jeopardize the availability of credit and choice of products, and shrink business activity.

In conclusion, to protect and grow our Nation's small businesses and economy, it is essential to get financial reform right. The best financial reforms will protect small businesses from being crushed by the destabilizing effects when a giant financial institution stumbles. Financial reforms that preserve and strengthen the viability of community banks are key to a diverse and robust credit market for small business.

Thank you.

Chairwoman VELÁZQUEZ. Thank you, Mr. MacPhee.

[The statement of Mr. MacPhee is included in the appendix.]

Chairwoman VELÁZQUEZ. Our next witness is Mr. Austin Roberts, the CEO of the Bank of Lancaster, Virginia. The Bank of Lancaster was founded in the northern neck of Virginia in 1930. Mr. Roberts is testifying on behalf of the American Bankers Association. ABA is the trade group and professional association representing the Nation's banking industry.

STATEMENT OF AUSTIN ROBERTS

Mr. ROBERTS. Chairwoman Velázquez, Ranking Member Graves, members of the committee, my name is Austin Roberts. I am Vice Chairman, President and CEO of the Bank of Lancaster, which is headquartered in Kilmarnock, Virginia. I am pleased to be here on behalf of the ABA.

Small businesses, including banks, are certainly suffering from the severe economic recession. This is the not the first recession faced by banks. Many banks have survived the ups and downs of the economy; mine has survived those for the last 80 years. In fact, most banks have been in their communities for decades and intend to continue to be there for decades.

We are not alone, however. In fact, there are more than 2,500 banks, 31 percent of the banking industry, that have been in business for more than a century; 5,000 banks have served their communities for more than half a century. These numbers tell a dramatic story about the staying power of banks and their commitment to the communities they serve.

The success of small entrepreneurial businesses are very important to my bank. My bank's focus and those of my fellow bankers throughout the country is on developing and maintaining long-term relationships with these and other customers.

In this severe economic environment, it is natural for businesses and individuals to be more cautious. Businesses are reevaluating their credit needs, and as a result, loan demand is also declining. Banks, too, are being prudent in underwriting, and our regulators are demanding it. In fact, in some cases, overly restrictive rules and examinations are hampering the banks' ability to make new loans.

While a great deal of attention is rightfully being paid to the administration's regulatory proposal, I would like to share with you other issues that banks like mine are facing.

First, the most important threat is the very high premiums being paid by banks to the FDIC. For example, my bank paid $75,000 in premiums in 2008. This year we will pay $550,000 in premiums, with the possibility of it even going to $700,000.

There is no question that the industry fully backs the financial health of the FDIC, but such large expenses have a very strong dampening effect on bank lending. ABA has detailed options in a letter to FDIC Chairman Bair that meet the funding needs without creating a financial burden on banks that could reduce bank lending and hurt the economic recovery.

Second, ABA is continuing to hear from bankers that regulators are demanding increases in capital and that banks improve the quality of their capital. With capital markets still largely unavailable, especially for community banks, the only course of action in the short run is to reduce lending in order to improve the bank's capital ratio.

Third, the recession has strained the ability of some borrowers to perform, which often leads the examiners to insist that a bank make a capital call on their borrower, impose an onerous amortization schedule or obtain additional collateral. These steps can set in motion a death spiral where the borrower has to sell assets at fire sale prices to raise cash, which then increases the write-downs that the banks have to make, and the cycle goes on and on.

These actions are completely counter to the notion of working with customers to make sure that credit is available to them or working with borrowers that may even be in distress.

There is much more included in my written testimony that details the difficulties that have arisen in the past year, but I want to take a moment to mention one idea that ABA has to increase capital to community banks in areas most hard hit by recession. Banks in these areas are doing everything they can to make credit available, but it is against the significant headwinds of losses from problem loans.

The idea, which the ABA shared in a letter to Secretary Geithner 2 days ago, would be to modify Treasury's existing capital assistance program to help well-managed, viable community banks access capital. These banks would match any investment the Treasury makes with private equity.

In this way, a relatively small sum of money, say, $5 billion invested by Treasury, matched by $5 billion in private equity, would bring all small banks' capital to levels significantly higher than regulators require to be well capitalized. Having additional capital will provide a cushion for these banks to meet the credit needs of their communities rather than reducing lending to meet regulatory capital requirements.

I want to thank you for the opportunity to present these views on challenges ahead for banks that serve small businesses, and I am happy to answer any questions.

Chairwoman VELÁZQUEZ. Thank you, Mr. Roberts.

[The statement of Mr. Roberts is included in the appendix.]

Chairwoman VELÁZQUEZ. Our next witness is Bill Hampel, the Senior Vice President of Research and Policy Analysis for the Credit Union National Association. CUNA provides many services to credit unions, including representation, information, public relations, and business development.

Welcome.

STATEMENT OF BILL HAMPEL

Mr. HAMPEL. Thank you. Chairwoman Velázquez, Ranking Member Graves, and other members of the committee, thank you very much for the opportunity to testify at today's hearing on behalf of the Credit Union National Association, which represents over 90 percent of our Nation's 8,000 State and Federal credit unions, the State leagues, and their 92 million members. I am Bill Hampel, the Chief Economist.

Credit unions did not contribute to the recent financial debacle, and their current regulatory regime, coupled with their cooperative structure, militates against credit unions ever contributing to a financial crisis.

As Congress considers regulatory restructuring, it is important that you not throw out the baby with the bathwater. Regulatory restructuring should not just mean more regulation. There needs to be recognition that in certain areas, such as credit unions, regulation and enforcement is sound and regulated entities are performing well.

Credit unions have several concerns in the regulatory restructuring debate. These include the preservation of the independent regulator, the development of the CFPA, and the restoration of credit unions' ability to serve their business-owning members.

First, it is critical that Congress retain an independent credit union regulator. Because of credit unions' unique mission, governance, and ownership structure, they tend to operate in a low-risk, member-friendly manner. Applying a bank-like regulatory system to this model would threaten the benefits that credit unions provide their members.

There is some logic for consolidating bank regulators where competition can lead to lax regulation and supervision, but that condition does not exist for credit unions which have only one Federal regulator, the National Credit Union Administration. The general health of the credit union system proves that our system works well.

Considering the CFPA, consumers of financial products, especially those provided by currently unregulated entities, do need greater protection. CUNA agrees that a CFPA could be an effective way to achieve that protection, provided that the agency does not impose redundant or unnecessary regulatory burdens on credit unions. In order for a CFPA to work, consumer protection regulation must be consolidated and streamlined to lower costs and improve consumer understanding.

CUNA strongly feels that the CFPA should have full authority to write the rules for consumer protection, but for currently regulated entities, such as credit unions, the examination and enforcement of those regulations should be performed by the prudential regulator that understands their unique nature. Under this approach, the CFPA would have backup examination authority.

CUNA urges Congress to take the difficult step of preempting State consumer protection laws if establishing a CFPA. We are confident that by creating a powerful Federal agency with the responsibility to regulate consumer protection law, with rigorous congressional oversight, more than adequate consumer protection will be achieved. And if the CFPA is sufficiently empowered to ensure nationwide consumer protection, why should any additional State rules be necessary?

Conversely, if the proposed CFPA is not expected to be up to the task, why even bother establishing such an agency in the first place?

Finally, because they are already significantly regulated at the State level, we don't believe that certain types of credit life and credit disability insurance should be under the CFPA.

As Congress considers regulatory restructuring legislation, CUNA strongly urges Congress to restore credit unions' ability to properly serve the lending needs of their business-owning members. There is no economic or safety and soundness rationale to cap credit union business lending at 12.25 percent of assets.

Before 1998, credit unions faced no statutory limit on their business lending. The only reason this restriction exists is because the banking lobby was able to leverage the provision when credit unions sought legislation to permit them to continue serving their members.

The credit union business lending cap is overly restrictive and undermines America's small businesses. It severely limits the ability of credit unions to provide loans to small businesses at a time when these borrowers are finding it increasingly difficult to obtain credit from other types of financial institutions, as was described by Mr. Hirschmann from the U.S. Chamber in the previous panel. It also discourages credit unions that would like to enter the business lending market from doing so.

We are under no illusion that credit unions can be the complete solution to the credit crunch that small businesses face, but we are convinced that credit unions should be allowed to play a bigger part in the solution.

Eliminating or expanding the business lending cap would allow more credit unions to generate the portfolios needed to comply with NCUA's regulatory requirements and would expand business loans to many credit union members, thus helping local communities and the economy. Credit unions would do this lending prudently; the loss rate on business loans at credit unions is substantially below that of commercial banks.

A growing list of small business and public policy groups agree that now is the time to eliminate the statutory credit union business cap for credit unions. And in July, Representatives Kanjorski and Royce introduced H.R. 3380, the Promoting Lending to America's Small Business Act, which would increase the credit union business lending cap to 25 percent of total assets and change the size of a loan to be considered a business loan. We estimate that credit unions could safely and soundly lend an additional $10 billion in small loans in the first year after enactment of such a bill.

Madam Chairwoman, thank you very much for convening this hearing, and I look forward to answering the committee's questions.

Chairwoman VELÁZQUEZ. Thank you.

[The statement of Mr. Hampel is included in the appendix.]

Chairwoman VELÁZQUEZ. We have three votes, so the committee will stand in recess and reconvene after these votes.

[Recess.]

Chairwoman VELÁZQUEZ. The committee is called to order.

Our next witness is Mr. John Moloney. He is President and CEO of Moloney Securities in Manchester, Missouri. Mr. Moloney began his career in brokerage over 30 years ago. In the mid-1990s, Mr. Molony formed Moloney Securities. He is the Chairman of SIFMA's Small Firms Committee and serves on FINRA's Advisory Board for small brokerage.

Thank you and welcome.

STATEMENT OF E. JOHN MOLONEY

Mr. MOLONEY. Thank you. Good afternoon, Chairwoman Velázquez, and Ranking Member Graves is not here, but the rest of the committee. Thank you for the opportunity to testify before you on behalf of SIFMA on how changes to the financial regulatory system could affect small broker-dealers.

SIFMA and its small member firms applaud your efforts to be the advocate on behalf of small businesses. Small businesses are the backbone of the U.S. economy and small broker-dealers are instrumental in serving individual investors and entrepreneurs on Main Street.

I will forgo the statistics for the industry and my company. They are in my written testimony. The only thing want to add is—the last line I have here is that my firm, like the overwhelming majority of broker-dealers, was not a TARP recipient.

The majority of financial service reform proposals before Congress do not impact smaller firms like mine. However, small firms are concerned that changes contemplated for large global financial service firms could cause disparate effects on small firm operations.

Because the investor confidence in these markets is important to all firms, regardless of size, a sound regulatory regime must contain several key elements.

It must minimize systemic risk, promote safety and soundness of the regulated entities, promote fair dealing and investigator protection, be consistent from country to country where applicable, and be as effective and efficient as possible. Well crafted and thoughtful legislation is needed to avoid unintended consequences that the firms that I am representing did not cause.

Congress should also include sunset provisions under the new laws and regulations so that they may achieve their desired effect and do not promote any undesired consequences.

I would like to address two specific features of the financial service reforms that do affect my firm and my brokers.

First, SIFMA has long advocated the modernization and harmonization of disparate regulatory regimes for brokers, dealers, investment advisors and other financial intermediaries. We welcome Treasury's proposed legislation, which appears to acknowledge these important distinctions and which would give the SEC the authority to establish rules for a new uniform Federal fiduciary standard that supersedes and improves on existing standards and is applied only in the context of providing personalized investment advice to individual investors.

Second, predispute arbitration clauses are vital to the securities arbitration system. Small investors benefit in particular, as arbitration allows them to pursue claims they could not afford to litigate and do it on a much more timely basis. Treasury has proposed giving the SEC the authority to prohibit predispute arbitration clauses in broker-dealer and investment advisory account agreements with retail clients if it studies these clauses and concludes that there is any harm on investors. SIFMA supports that provision.

There are several issues that impact regulation of smaller firms that I would like to address. While each one may be insignificant, taken as a whole the cumulative effect can be quite devastating. For example, fees for financial audits of small firms will increase due to the SEC's decision not to extend an exemption from small firms' Sarbanes-Oxley audit requirements. FINRA has proposed to eliminate anti-money-laundering third-party exemption for small firms; this will increase AML audit costs. SIPC, FINRA, and the MSRB have proposed or implemented increased assessments to firms already. The cumulative impact of these and other changes drain limited resources from small firms and from their efforts in paying for the compliance training and customer service functions.

Finally, SIFMA supports the small business community initiative to correct deficiencies in Reg X to eliminate outdated regulations, ensure agencies do not ignore the requirements of Reg X, and compel agencies to consider economic impacts on the rules of small business.

Thank you, Madam Chairwoman and the rest of the committee for allowing me to present SIFMA's views. We hope to continue the dialogue on the financial service regulatory reform and stand ready to assist any way we can.

Chairwoman VELÁZQUEZ. Thank you, Mr. Moloney.

[The statement of Mr. Moloney is included in the appendix.]

Chairwoman VELÁZQUEZ. Our next witness is Ms. Dawn Donovan, the CEO of Price Chopper Employees Federal Credit Union in Schenectady, New York. Price Chopper has over 6,500 members with assets of $16 million. Ms. Donovan is testifying on behalf of the National Association of Federal Credit Unions. The Association of Federal Credit Unions was founded in 1967 to shape the laws under which Federal credit unions operate.

Welcome.

STATEMENT OF DAWN DONOVAN

Ms. DONOVAN. Good afternoon, Chairwoman Velázquez, Ranking Member Graves, and members of committee. My name is Dawn Donovan, and I am testifying today on behalf of the National Association of Federal Credit Unions, NAFCU. I serve as the President and CEO of Price Chopper Employees Federal Credit Union in Schenectady, New York. Our credit union has seven employees, approximately 4,500 members in six States and just over $19 million in assets.

NAFCU and the entire credit union community appreciate the opportunity to participate in this discussion regarding financial regulatory restructuring and its impact on America's credit unions.

It is widely recognized that credit unions did not cause the current economic downturn; however, we believe we can be a important part of the solution. Credit unions have fared well in the current economic environment and as a result many have capital available.

Surveys of NAFCU member credit unions have shown that many are seeing increased demand for mortgage and auto loans as other lenders leave the market. Additionally, a number of small businesses who have lost important lines of credit from other lenders are turning to credit unions for the capital that they need. Our Nation's credit unions stand ready to help in this time of crisis and unlike other institutions have the assets to do so.

Unfortunately, an antiquated and arbitrary member business cap prevents credit unions from doing more for America's small business community. It is with this in mind that NAFCU strongly supports H.R. 3380, the Promoting Lending to America's Small Businesses Act of 2009. This important piece of legislation would raise the member-business lending cap to 25 percent of assets, while also allowing credit unions to supply much-needed capital to underserved areas which have been among the hardest hit during the current economic downturn.

NAFCU also strongly supports the reintroduction of the Credit Union Small Business Lending Act, which was first introduced by Chairwoman Velázquez in the 110th Congress.

As the current Congress and administration mull regulatory reform, NAFCU believes that the current regulatory structure for credit unions has served the 92 million American credit union members well. As not-for-profit member-owned cooperatives, credit unions are unique institutions in the financial services arena and make up only a small piece of the financial services pie.

We believe that NCUA should remain the independent regulator of credit unions and are pleased to see the administration's proposal would maintain this independence as well as the Federal credit union charter.

NAFCU also believes that the proposal is well intentioned in its effort to protect consumers from the predatory practices that led to the current crisis. We feel there have been many unregulated bad actors pushing predatory products onto consumers, and we applaud efforts to address this abuse.

It is with this in mind that we can support the creation of the Consumer Financial Protection Agency, CFPA, which would have authority over nonregulated institutions that operate in the financial services marketplace. However, NAFCU does not believe such an agency should be given authority over regulated federally insured depository institutions, and opposes extending this authority to credit unions.

As the only not-for-profit institutions that would be subject to the CFPA, credit unions would stand to get lost in the enormity of the proposed agency. Giving the CFPA the authority to regulate, examine, and supervise credit unions, already regulated by the NCUA, would add an additional regulatory burden and cost to credit unions. Additionally, it could lead to situations where institutions regulated by one agency for safety and soundness find their guidance in conflict with the regulator for consumer issues. Such a conflict will result in diminished services to credit union members.

Credit unions already fund the budget for NCUA. As not-for-profits, credit unions cannot raise moneys from stock sales or capital markets. This money comes from their members' deposits, meaning credit union members would disproportionately feel the cost burden of a new agency.

However, NAFCU also recognizes that more should be done to help consumers and look out for their interests. We would propose that rather than extending the CFPA to federally insured depository institutions, each functional regulator create a new strengthened office on consumer protection.

We were pleased to see the NCUA recently announce its intention to create such an office. Consumer protection offices at the functional regulators will ensure those regulating consumer issues have knowledge of the institutions they are examining and guidance on consumer protection. This is particularly important to credit unions as they are regulated and structured differently from others.

We believe such an approach would strengthen consumer protection while not adding unnecessary regulatory burden. Part of avoiding that burden will be to maintain a level of Federal preemption so small institutions like mine, with members in several States, are not overburdened by a wide variety of State laws.

In conclusion, while there are positive aspects to consumer protection and regulatory reform, we believe Federal credit unions continue to warrant an independent regulator handling safety and soundness and consumer protection matters.

I thank you for the opportunity to appear before you on behalf of NAFCU and would welcome any questions that you may have.

Chairwoman VELÁZQUEZ. Thank you, Ms. Donovan.

[The statement of Ms. Donovan is included in the appendix.]

Chairwoman VELÁZQUEZ. I am going to ask this question to everyone. I will ask everyone to answer, even though I anticipate the answers that you will provide—but just to be on the record.

As you know, the President laid out five core elements for reform in his white paper, and these include stronger supervision of institutions, comprehensive supervision of financial markets, enhanced consumer protection, the creation of tools for financial crisis, and increasing international cooperation.

In your opinion, which of these elements should be prioritized? Mr. MacPhee?

Mr. MACPHEE. I think given what we have just come through in this country, and the lack of regulation on the unregulated—and oversight—and the dismal position that we found ourselves in when the smoke cleared in terms of the funding of our reserve for FDIC insurance, et cetera, I think oversight has to be the first priority. And I think the systemic risk in our whole system has to be priority.

Chairwoman VELÁZQUEZ. Mr. Roberts.

Mr. ROBINSON. Madam Chair, I would think also that the issues surrounding systemic risk and surrounding those organizations that previously were unregulated or underregulated are the most important items to address among those items that you talked about.

Chairwoman VELÁZQUEZ. Thank you.

Mr. Hampel.

Mr. HAMPEL. I would agree with those comments. One thing the Congress needs to be concerned about is, right now there is a fervor to do regulatory reform because we are still in the latter stages of the crisis. And that is perhaps not the best time to make significant changes when we are so caught up in the moment.

The risk is, if we wait too long, by the time we have had enough time to study it properly, there will not be sufficient impetus do it—extending some form of regulation to the currently unregulated.

Chairwoman VELÁZQUEZ. Mr. Moloney.

Mr. MOLONEY. Again, I think the systemic element has to be dealt with as a high-priority item.

I would also maybe go to the other end and start with the consumer protection and move up from there. Between those two, I think you can cover a lot of ground towards making it a more effective and fair playing field.

Chairwoman VELÁZQUEZ. Okay.

Ms. Donovan.

Ms. DONOVAN. Madam Chair, I would say our position would be the systemic risk. But also the regulation of the unregulated, pretty much as Mr. Hampel and the other members of this panel have said.

Chairwoman VELÁZQUEZ. Thank you.

Mr. Roberts and Ms. Donovan, during times of financial duress, higher capital requirements can provide a cushion for lenders. But these increased levels can also restrict a bank or credit union's ability to make loans to small firms.

Can you talk about how higher capital requirements might impact your small business lending practices?

Mr. ROBERTS. I think that is really a very good question.

In my testimony, I spoke about the fact that in 2008, my bank paid $75,000 in FDIC insurance. In 2009, that number could be anywhere between $550,000 and $700,000.

When you start looking at those numbers, what in turn you see is, that means profitability. Money that is going to go into the capital of our organization is going to be reduced by $475,000 to about $600,000. In turn, what that relates to is capital to support loans, loans that might be available, supported by that capital, could be anywhere from $5 million to $7 million less. That is certainly going to impact our ability to lend to small businesses as well as customers as a whole.

As those capital requirements get to be tighter, it certainly does provide an additional safety net, but one has to keep in mind that it is also going to restrict lending.

Chairwoman VELÁZQUEZ. And then there will be other people that will say that the risk to taxpayers and depositors goes down.

Mr. ROBERTS. I would—my response to you is, I think there is a practical level of capital that can satisfy both sides of that particular equation.

We talked earlier—I think at the prior panel—that some people were leveraged 30-to-1; that is probably too much. Is 5-to-1 too little? I would suggest that it is. I think there is a capital level that is a reasonable balance that continues funds able to be lent and still provides that safety to the taxpayer.

Chairwoman VELÁZQUEZ. Ms. Donovan?

Ms. DONOVAN. Madam Chair, most credit unions today have sufficient capital. We have good capital on hand. Unfortunately, the artificial cap that is on member lending is what is refraining us from lending that out.

I am a very small credit union, as I noted. We have hardly any member-business lending, very little. However, we do have the capital to lend to the small businesses in our community. And most credit unions do have that at this point.

Chairwoman VELÁZQUEZ. Okay.

Mr. Moloney, up until the financial crisis, the economy experienced a decade of relatively solid growth, and during this time we saw an explosion of financial innovation and all of the products that went with it.

Are you concerned that the proposed regulation might reverse this trend of financial innovation?

Mr. MOLONEY. Good question.

″Yes″ is the short answer, but I probably would like to also state that I think that it is very possible that with the creation of these innovative products, we may have gotten ahead of ourselves and had things that people really did not fully think out and sold to clients who didn't have a clue.

So maybe the answer is ″yes.″ I want to have that ability, but I also want to make sure that the people who are involved on the buying and the selling side of it know the products that they are dealing with.

Chairwoman VELÁZQUEZ. Mr. MacPhee and Mr. Hampel, addressing systemic risk will be an essential element of the reform proposal. As you noted in your testimony, community banks are smaller and are much less interconnected than larger international institutions. Even so, community banks can still transmit risk into the financial system.

In light of this, should community banks or all credit unions be subject to systemic regulation?

Mr. HAMPEL. Well, Madam Chair, speaking for credit unions, my understanding of systemic risk is such that if even the largest 10 credit unions were all to get into extreme difficulty at same time, it would not spread to the rest of the financial system. So I don't think that credit unions could ever be the source of systemic risk, just by the nature of their size.

However, credit unions, because they are connected and users of the rest of the financial system, can be victims of the systemic risk of other institutions; and that is why we are interested in the issue.

Chairwoman VELÁZQUEZ. Okay.

I have other questions, but I will—

Mr. GRAVES. I will pass, Madam Chair, for now.

Chairwoman VELÁZQUEZ. Mr. Westmoreland?

Mr. WESTMORELAND. Thank you, Madam Chair.

Let me say—you know, the first panel we talked about unintended consequences. And, Mr. Roberts, you hit the nail on the head with your testimony about being the victims of somebody else doing some wrong things in the banking industry.

You understand that our concern about some of these new agencies that are created, we don't know what the rules and regs are going to be. And that is basically what has happened with some of the legislation that we have passed recently not knowing how the regulators are going to go out into these banks and enforce certain regulations that Congress really does not have any control over.

Now, I know from talking to some of my independent bankers and community bankers that—how many sets of regulators, Mr. Roberts, does the typical bank have in Virginia? Are you in Michigan or Virginia?

Mr. ROBERTS. I am in Virginia.

Mr. WESTMORELAND. Virginia?

Mr. ROBERTS. We are—again, with a dual banking system, we are a State-chartered bank that happens also to be a member of the Federal Reserve System. We are regulated by the Commonwealth of Virginia and we are also regulated by the Federal Reserve.

Mr. WESTMORELAND. How many sets of regulators do you have come in?

Mr. ROBINSON. We will have, in any particular year, at least two examinations. One would be a safety and soundness examination by either the State or the Federal Reserve. The second would be a consumer affairs examination that is solely looking at our adherence to consumer protection laws; that is done by the Federal Reserve.

I think it was stated earlier in this testimony that I fully believe that the prudential regulator, the one who has responsibility for safety and soundness, ought to have responsibility for consumer affairs.

I would also share with the committee, about 6 weeks ago we just completed a consumer affairs examination by the Federal Reserve. Prior to that examination, we received a questionnaire from the Federal Reserve, probably 45-50 pages long, requesting a number of documents, as well as questions. We had 14 examiners come into our bank for 2 weeks to review all of those issues that they thought might have arisen through that pre-questionnaire.

I would suggest to you that it was a very extensive, fully complete examination that is entirely separate from safety and soundness.

Mr. WESTMORELAND. On top of that we had another knee-jerk-reaction kind of thing in Congress actually before I got here, Sarbanes-Oxley.

Could you tell me, due to that knee-jerk reaction, how much that costs the average bank? I know you said your FDIC premiums went from 75 to 5 and something.

What kind of cost and what kind of audit does the Sarbanes-Oxley law bring to the banking business?

Mr. ROBINSON. We have done regular reviews of the cost of Sarbanes-Oxley at our bank. The cost, year in and year out, approaches $250,000 to $275,000. We have right at 2.5 million shares of stock outstanding.

I have shared with my shareholders at annual meetings the cost is about 10 cents a share. If you are at a trading volume of 10 times earnings, that is going to be a dollar a share. At 16 times earnings that is a $1.60 a share that takes place year in and year out. And I would suggest that my shareholders hardly see the benefit of that reaction.

Mr. WESTMORELAND. Thank you.

Mr. Moloney, when we talk about things being underregulated, we had the credit default swaps which, if I understand correctly, is a company that was offering insurance on something that they were selling that was not regulated to offer insurance, so they came up with a product called a credit default swap.

Is that basically what that is in a common language?

Mr. MOLONEY. It is an element that our firm was never involved with.

Mr. WESTMORELAND. There is somewhere down the line with the credit default swap and all of these derivatives and stuff that, to me, somebody that was—these companies are regulated. The SEC or somebody should have caught this, and I don't know if it was underregulation or the lack of enforcement in people wanting to expose some of these programs that were out there.

But the problem that we are having—and I am in Georgia, and we have had more failed banks that anywhere else, and what is happening is—Mr. Roberts, you spoke of this—the regulators are coming in and changing the way some of these banks, that had a good business going on, are able to lend money, how much cash reserves they have got to have versus how much money they are able to lend; reduction in real estate portfolios that are performing assets, but they are wanting them reappraised, more cash put in the deal. And it is really a snowball effect.

And Madam Chair, I will yield. I know I have taken more time than the light. But—I would like to have at least one more round of questioning, if that is possible, but I yield back to you.

Chairwoman VELÁZQUEZ. You can continue.

Mr. WESTMORELAND. Thank you, ma'am.

From what I see, the problem is that—Mr. MacPhee, being a community bank, I would like to hear from you too.

Because what it seems like, when we passed the TARP legislation, we were told that this was going to be used to free up the credit market. And it has had, to me, just the opposite effect on freeing up the credit market.

It has already created a snowball effect of real estate values. What is going on in the marketplace; the banks that did get the TARP money are using this just to straighten up their books. And if you look at Goldman Sachs, and Bank of America talked about they made billions of dollars, they were able to buy these assets for 10 to 20 cents on the dollar and then sell them for 30 or 40 cents on the dollar, so they really did have a value there.

But to clean up their books and to do what some of these regulators were making them do, people were losing their retirement, they were losing their equity, they were losing all the cash that they had put in the deal, now that they can no longer get out. It has had just the reverse effect on that.

And that is what concerns me about some of this big legislation that we are talking about is, some of these unintended consequences of possible rules and regs that can be written and enforced by some agencies that we really have no control over.

Could you comment on some of that?

Mr. MACPHEE. Yes, thank you. I am no expert on TARP. I do know that at the time that TARP was put into place and the institutions that were qualified for and took TARP, it was an important step in reassuring the public that the financial institution system in this country was going to go on. So I don't fault them for that.

I think that being from a community bank, we are a $77 million bank and have 13.7 percent to capital and 29 percent liquidity. It is not a model that you see very often today. When the others were paying out 75 percent in dividends and retaining 25 percent, our model was the opposite. We were paying out 25 percent and retaining 75 percent.

I am not saying that we are right and they are wrong. But there was a happy medium in there. I think both the unregulated and the systemically risky, which I would define as those banks over $100 billion could wreak havoc on society again, and did need TARP money to survive.

The community banks today, I can tell you, are willing and ready to loan. I have money. Unfortunately for me, I live in a State where the unemployment is so high that I am not seeing the loan value that you might see in other areas.

Mr. WESTMORELAND. I will have you open up a branch in Georgia. We have borrowers down there.

One thing for the credit union, you don't belong to the FDIC, right?

Ms. DONOVAN. Correct. We are regulated by the NCUA.

Mr. WESTMORELAND. What kind of fees do you pay them for your deposits?

Ms. DONOVAN. On average to NCUA, it might be a $1,000 or $1,500, what it might cost me. It does not seem like a lot of money, I am sure. However, I have seven employees including myself—six, full-time; one, part-time—and we take care of all 4,500 members over the six States.

In the whole scheme of things, it is a lot of money for us. My payroll is very slim. I take on many roles.

Mr. WESTMORELAND. But do you have to pay a premium for what your deposits are, what they guarantee? They guarantee your deposits, right?

Ms. DONOVAN. Correct.

Mr. WESTMORELAND. So your fee for your deposits would be 1,500 bucks?

Ms. DONOVAN. Yes.

Mr. HAMPEL. This year, credit unions will pay an insurance premium of 15 basis points of their insured shares, which is higher than what it normally is for credit unions, but it is because of losses, collateral damage credit unions have experienced.

We typically fund our system by credit unions makeing deposits into the fund, and it is the earnings from those deposits that the insurance fund uses to operate. Probably, for the next several years, credit unions will be paying premiums of about 15 basis points. It is probably less than what FDIC-insured institutions will pay, but it is significant compared to what credit unions have historically paid.

Mr. WESTMORELAND. Thank you.

I yield back, Madam Chair.

Chairwoman VELÁZQUEZ. Thank you.

Mr. MacPhee, I would like to ask my last question to you. It is regarding securitization that has been billed as one of the chief culprits in the financial crisis. At the same time it has been credited with increasing the availability of capital for small firms.

To what degree does your bank take advantage of loan securitization, and do you believe it should be constrained going forward?

Mr. MACPHEE. Our bank has basically used Fannie and Freddie secondary market for liquidity purposes and for helping out with our capital situation.

We tend to retain most of our loans in our bank. We still do a 5-year balloon mortgage for our customers, and I think—one of the things that we have to do as a community bank is, relationship banking rather than transactional banking. So the structure out there for most community bankers that I deal with, it is important to have securitization and collateralization and selling off to the secondary market to keep liquidity in the system.

Chairwoman VELÁZQUEZ. Mr. Roberts.

Mr. ROBERTS. I would agree with you wholeheartedly that securitization has been a part of the problem that has been created in our economy. And I would agree with you wholeheartedly that securitization is one of those avenues that has allowed greater lending to take place. It has provided additional liquidity, additional funding to come into financial institutions that have allowed for continuing loans to take place.

It would seem to me, however, that it has been a part of what has caused some systemic risk; and I think that we need to consider what regulations that we can put into place that would not allow the issues that have happened over the past 12 months to happen again. But that does not mean throwing the baby out with the bathwater and stopping securitization. That has been a very important factor in the ability of this country to go forward.

Chairwoman VELÁZQUEZ. Very good.

Does any other member wish to ask questions?

Let me take this opportunity thank all of you. This has been very insightful, and as a member of the Financial Services Committee, it helps me to bring a different perspective into the debate. And so, for that, I really appreciate all your cooperation and being here today. Thank you.

I ask unanimous consent that members will have 5 days to submit a statement and supporting materials for the record.

Without objection, so ordered.

This hearing is now adjourned.

[Whereupon, at 4:53 p.m., the committee was adjourned.]

NYDIA M. VELAZQUEZ, NEW YORK
CHAIRWOMAN

SAM GRAVES, MISSOURI
RANKING MEMBER

Congress of the United States

U.S. House of Representatives

Committee on Small Business

2361 Rayburn House Office Building
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Statement
of the
Honorable Nydia M. Velázquez, Chair
House Committee on Small Business
Full Committee Hearing: *"The Impact of Financial Regulatory Restructuring on Small Businesses and Community Lenders"*
September 23, 2009, 1 p.m.

One year ago this month, we saw the largest bankruptcy in U.S. history when Lehman Brothers filed for Chapter 11. The following weeks were a whirlwind of activity. The FDIC seized Washington Mutual, selling the company's banking assets to JP MorganChase. Wachovia was acquired by Wells Fargo, and Merrill Lynch by Bank of America. Attempting to provide relief to our teetering financial system, Congress passed and President Bush signed into law the $700 billion TARP legislation.

Since then, it has become evident that the problems leading up to this crisis did not accumulate overnight. In fact, flaws in our risk management systems – both governmental regulations and private mechanisms – had been growing for decades.

In coming weeks, Congress and the Administration will examine options for strengthening our regulatory structure. This is long overdue. The gaps in the system have grown too large to be ignored. We cannot count on current regulations to prevent another crisis.

While considered by many an issue for the financial services industry, how we address those gaps will be critical for all small businesses. It is imperative that, as we look at alternatives for updating our financial regulations, we carefully consider how these changes might affect entrepreneurs.

Small businesses rely on the healthy functioning of our financial systems in order to access capital. New rules governing how financial institutions extend credit will directly affect entrepreneurs seeking loans at affordable rates. The biggest challenge facing small firms right now is access to affordable capital. We must be careful that regulatory changes do not exacerbate the current capital shortage, and undercut our recovery as it begins to take hold.

Likewise, financial regulatory reform could unintentionally touch sectors of the small business community that we do not think of as financial institutions. Businesses that allow customers to

---over---

pay for goods and services after delivery are essentially extending "credit." Congress and the Administration must be careful not to define the term credit too broadly. Otherwise, businesses like home builders, physicians and others may face new rules that were not meant for them.

Small businesses come in all shapes and sizes and there are many in the financial sector. Community banks and credit unions could see their business models profoundly affected by many of the proposed changes. Small firms in the financial sector often face higher compliance costs than their larger competitors. Several proposals would result in small lenders answering to a new regulatory entity. I expect some of our witnesses today will testify that small lenders bear less responsibility for the recent turmoil and, therefore, should not carry the brunt of new regulations. This argument seems to carry at least some credibility – the Committee should consider it carefully as we proceed.

As both lenders and borrowers, small businesses have much at stake when it comes to regulatory reform. The financial crisis of last year and the recession it triggered have hit small firms hard. As much as anyone, entrepreneurs want these problems fixed so that financial markets can again play their vital role in promoting commerce.

Numerous strategies have been floated for restoring transparency and stability to our financial systems. Depending on how they are crafted, these proposals could touch every sector of the American economy. For these reasons, we have invited representatives from a range of industries to testify. It is my hope that their testimony will add important perspectives to the discussion.

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U.S. HOUSE OF REPRESENTATIVES
SMALL BUSINESS COMMITTEE REPUBLICANS
REPRESENTATIVE SAM GRAVES, RANKING MEMBER

Opening Statement for Hearing on
The Impact of Financial Regulatory Restructuring on Small Business and Community Lenders
Sam Graves
Ranking Member
Committee on Small Business
United States House of Representatives
Washington, DC
September 23, 2009

I would like to thank the Chairwoman for holding this important hearing on the debate that will occur about restructuring regulatory oversight of America's financial sector. Given the fact that the financial services sector contributed more than a third of corporate profits in the country during the last decade, it is a significant debate.

No one can question that the events affecting Wall Street last year had consequences on the overall American economy. Once credit becomes unavailable, the modern economy comes to a grinding halt. Consumers and businesses do not buy, manufacturers do not sell, and unemployment skyrockets. Any reform to the financial regulatory process must meet two key objectives. First, it must provide for an efficient operation of the financial markets. Second, small businesses, the prime generator of new jobs in the economy, must have access to capital.

Competitive markets need full information to operate properly. To the extent that regulatory reform improves the information available to all parties that use the financial markets it will be beneficial. That benefit must be weighed against the cost of providing information.

Much of the focus on financial regulatory reform proposals addresses either protecting consumers or preventing one or a group of institutions that create systemic risk leading to a collapse of capital and credit markets. However, little has been said on the impact that such regulatory oversight might have on the access to capital for small businesses. If the regulatory reform inhibits the ability of small businesses to obtain credit or access needed capital the regulation will have an adverse long-term consequence on the ability of the economy to grow.

A famous philosopher once said "that those who cannot remember the past are condemned to repeat it." Whatever the outcome of the debate on restructuring the regulation of the financial sector, we cannot repeat the mistakes of the past. Given the fact that financial panics have periodically occurred in this country going back to 1837, achieving a regulatory restructuring that ensures Congress does not repeat the mistakes of the past will be one of our most difficult tasks.

Again, I would like to thank the Chairwoman for holding this important hearing and yield back the balance of my time.

TESTIMONY OF

THE AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

Before The

HOUSE COMMITTEE ON SMALL BUSINESS

THE IMPACT OF FINANCIAL REGULATORY RESTRUCTURING ON SMALL BUSINESS AND COMMUNITY LENDERS

September 23, 2009

Chairwoman Velazquez, Ranking Member Graves and Members of the House Committee on Small Business, I am Robert R. Harris, I am the vice chairman of the American Institute of Certified Public Accountants and managing partner of the accounting firm Harris, Cotherman, Jones, Price & Associates in Vero Beach, Florida. We are a small business with 11 CPAs in the firm. On behalf of the American Institute of Certified Public Accountants, I am pleased to present testimony regarding the impact of financial regulatory restructuring on small businesses.

The American Institute of Certified Public Accountants (www.aicpa.org) is the national, professional association of CPAs. AICPA has more than 360,000 CPA members in business and industry, public practice, government, education, student affiliates and international associates. We set ethical standards and U.S. auditing standards for the profession for audits of private companies, non-profit organizations, federal, state and local governments. We develop and grade the Uniform CPA Examination.

As a result of the economic crisis, President Obama on June 17, 2009 spoke on 21st Century financial regulatory reform. He called for a new foundation that requires "strong, vibrant financial markets, operating under transparent, fairly-administered rules of the road that protect America's consumers and our economy from the devastating breakdown that we've witnessed in recent years." To accomplish his goals, the president stated that it will be necessary to seek a careful balance that will "allow our markets to promote innovation while discouraging abuse."

The AICPA supports this goal and the approach. But we also believe it is critical to consider the plan's effect on small business to ensure that it does not stifle the innovation, creativity and inventiveness of the American entrepreneur that has driven our economic engine. If it is to flourish, small business cannot be overburdened with either direct or indirect regulation. It needs to be able to act in the marketplace without burdens that unduly restrict its ability to operate, and it needs to have access to credit and other services without undue impediments. This is a difficult balance to reach, but one that we must arrive at if we are to grow our economy in a manner that has appropriate safeguards.

These safeguards are both restrictions on actions and protection of consumers. The latter has not generally been a focus of policymakers in conjunction with the health of the overall economy. The recent economic crisis has shown us, however, that when a significant volume of loans is inappropriately made to consumers, consumers are not the only ones who are harmed. As we have seen, this can begin a process that freezes our credit markets and the economy as a whole.

We would like to focus on the consumer protection aspects of the president's plan and its effect on small business. The AICPA supports financial consumer protection. CPAs currently play a vital role in providing independent advice to their clients on their financial options and assisting them in tax planning and preparation of tax returns. CPAs also provide thousands of hours of pro bono financial literacy education to Americans.

There are approximately 43,900 small CPA firms in the United States, including 33,000 sole practitioners. These small firms have approximately 9 million small business clients of the 25 million small businesses (according to Small Business Administration data) in this country.

The work that CPAs perform for clients is based on each client's specific facts and circumstances, taking into account each client's needs. CPA services are unlike many other financial services in that they are not generic products that can be sold or performed broadly; rather, they are tailored individually.

H.R 3126, The Consumer Financial Protection Act (CFPA) of 2009, which was based on the administration's vision, goes beyond the regulation of the sale of products related to consumer credit and finance and would affect independent services provided in the context of professional relationships. This will negatively affect the ability of CPAs as small businesses to provide customary and usual services to their clients. It will also harm other small businesses because their ability to receive the services offered by CPAs will be adversely affected.

The definition of "financial activity" in the bill is so broad as to include many services that CPAs routinely provide to their clients in accordance with a very strict regulatory and oversight regime. The bill would result in redundant regulation of CPAs and certified public accounting firms that are already subject to appropriate and significant oversight by the IRS, Treasury, state boards of accountancy and professional and ethical standards for AICPA's members.

CPAs should not be exempt from CFPA regulation when acting outside of the provision of customary and usual services to their clients, and we support additional oversight of financial products, such as refund anticipation loans.

CPAs have a lifelong commitment and legal obligation to serve the public interest as efficiently and effectively as possible and are already heavily and sufficiently regulated. Subjecting CPAs and the tax, financial advice, financial education and other financial services that they and certified public accounting firms and their employees provide to millions of individuals and small businesses to the additional oversight proposed in CFPA will unnecessarily increase costs to consumers without adding corresponding benefits.

The public discussion of the need for the CFPA has focused on the way the current regulatory regime has gaps in supervision and enforcement with respect to lenders, especially sub-prime lenders. However, as currently written, the CFPA bill is much broader in scope. It encompasses any financial product or service to a consumer, including acting as a financial advisor. Acting as a financial advisor includes the preparation of tax returns, tax-planning advice, financial planning advice, general advice to small businesses and family businesses, and the provision of pro bono financial literacy education.

By making the reach of the CFPA so broad, the effectiveness of the agency will be naturally diluted. By having possibly millions of persons covered by the bill, the ability of the CFPA to adequately police each covered person is diminished. CPAs provide traditional financial services to clients and are strongly, effectively, and comprehensively regulated with regard to those services. The bill would subject these customary and usual CPA services to regulation by the CFPA.

The following is a description of the relevant provisions of H.R. 3126 and which CPA – client activities would be covered by the new agency.

The bill establishes the CFPA to regulate the provision of consumer financial products or services, enumerated consumer laws, and authorities transferred from other agencies. "Consumer financial product or service" (CFPS) is defined as any financial product or service used by a consumer primarily for personal, family, or household purposes.

A "covered person" is defined as any person who engages directly or indirectly in a financial activity, in connection with the provision of a CFPS; *or* any person who, in connection with the provision of a CFPS, provides a material service to, or processes a transaction on behalf of, a covered person. This is referred to as the "secondary trigger."

The bill broadly defines "financial activity" to include acting as a financial advisor. Acting as a financial advisor includes providing financial and other related advisory services, providing educational courses and instructional materials to consumers on individual financial management matters, or providing credit counseling, tax planning or tax preparation services.

The cumulative effect of these definitions means that CPAs and certified public accounting firms could be subject to regulation by the CFPA with regard to the following services to an individual because they would fall within one or more of the subsections that define financial activity. This list is illustrative and not exhaustive:

- Tax preparation and other compliance services including estimated income tax payments and trust and estate tax services
- Tax planning
- Tax audit representation
- Estate and retirement planning
- Personal financial planning
- Asset protection and wealth preservation
- Public service efforts related to financial literacy
- Forensic accounting
- Valuations
- Financial advice for the elderly
- Helping small businesses and family businesses.

In addition, the bill authorizes the CFPA to issue regulations or guidelines regarding the offer of a standard "plain vanilla" CPFS. How this may impact CPA services is not clear until the CFPA becomes operational.

As noted above, the definition in the act of a covered person is expansive. It includes the "secondary trigger," which exposes a service provider such as a CPA to the regulatory authority of the CFPA if the CPA provides "a material service" to a person who actually provides a CFPS to a consumer. CPAs provide a broad range of services to clients that are businesses rather than individuals. Any service provided to a financial services business would bring the CPAs within the regulatory scope of the CPFA. We believe that this is an unintended consequence. This goes far beyond a CPA or certified public accounting firm providing products to a consumer on behalf of a covered person. It intervenes in a relationship that is intended only to provide professional services to a covered company such as tax preparation and compliance services provided to a financial services company. Such services do not directly support the activities and products of the financial services company that would be regulated by the CFPA.

As I noted above, if a business client is providing a CFPS, the CPA and certified public accounting firm that provides any material service is automatically a covered person and is subject to the provisions of the legislation and to the authority of the CFPA.

This provision is even broader than its coverage of CPA services. For example, being a payroll service provider to a financial services business, or installing a new heating and air conditioning unit in a financial services company building are material services that would bring the payroll service and HVAC company under the authority of the CFPA.

CPAs support financial consumer protection and already play a vital role in advising Americans on their financial options and best interests. In addition, CPAs and certified public accounting firms are already comprehensively regulated in ways that fully protect the public. With regard to the regulation of CPAs, the goals of the CFPA are already being met under the existing regulatory structure. Subjecting CPAs to the CFPA would be an unnecessary, duplicative regulatory burden that would not provide any commensurate benefit to the public. Currently consumers can rely on comprehensive state regulation and licensure, IRS oversight through the Internal Revenue Code penalty structure and Circular 230, and the AICPA's Code of Professional Conduct and accompanying standards.

State Regulation and Licensure

State boards of accountancy license, regulate, and enforce state licensure laws and regulations with regard to all CPAs. They require CPAs to act with integrity, objectivity, due care, competence, full disclosure of any conflicts of interest, client consent if a conflict exists, maintenance of the confidentiality of all client information unless the client consents to the disclosure, disclosure to the client of any commission or referral fees, and to serve the public interest when providing any of these financial services.

State boards of accountancy also license and regulate accounting firms. The firms and CPAs who own the firms are responsible for ensuring that all employees and owners of accounting firms who are not CPAs comply with the same ethics and other rules as are applicable to CPAs.

Generally, states require CPA licensure for a person who holds himself out to the public as a CPA and/or who:

- Offer or performs professional services that involve or require an audit, examination, or review of financial transactions and accounting records.
- Renders professional services to clients in matters relating to accounting procedure and to the recording, presentation, or certification of financial information or data.
- Prepares or signs, as the tax preparer, tax returns for clients.
- Prepares personal financial or investment plans or provides to clients products or services of others in implementation of personal financial or investment plans.
- Provides management or financial consulting services to clients.

Education and Experience required for licensure as a CPA:

- Minimum college education requirements must be met. The typical requirement is 150 credit hours of college education with at least a baccalaureate degree and a concentration in accounting.

- Minimum experience levels must be reached before the CPA certificate is awarded. Most states require at least one year of experience providing services that involve the use of accounting, attest, compilation, management advisory, financial advisory, tax or consulting skills, all of which must be achieved under the supervision of or verified by a CPA.

CPA Examination: Must pass the Uniform CPA Examination.

Continuing Education: States typically require a significant level of continuing professional education to be completed in order to maintain a CPA license.

Compliance with Professional Standards: States typically require adherence to standards that align closely with the requirements of the AICPA's Code of Professional Conduct (discussed below).

Disciplinary Authority: State Boards of Accountancy hold the authority to impose penalties including revocation and suspension of licenses and imposition of administrative penalties. State Codes of Ethics include provisions that mandate integrity, objectivity, due care, confidentiality, and independence when providing services to clients. Penalties may also include fines, which may be substantial.

1. IRS Oversight of federal tax return preparation and federal tax advice

There is sufficient authority in the Internal Revenue Code for the IRS to impose penalties on tax preparers and to assure high standards of tax practice. Specific tax preparation oversight includes:

- Monetary penalties against tax return preparers: A tax return preparer is one who prepares, or employs others to prepare, for compensation all or a substantial portion of a federal tax return for another. A person providing tax advice is included within the definition of return preparer when (i) the item on which advice is given is a substantial portion of the return, (ii) the events generating the item have already occurred at the time the advice is given, and (iii) the advice is directly related to determining the existence, characterization, or amount of an entry on a return or claim for refund. Various penalties can be asserted against tax return preparers, some of which are listed below:
    - Section 6694 (understatement of taxpayer's liability) – A penalty can generally be imposed against a return preparer who prepares a return or claim for refund with respect to which there is an understatement of liability when the error resulted from an unreasonable position or reckless or willful behavior by the preparer.
    - Section 6695 (other failures) – A penalty can be imposed against a tax return preparer for failing to perform certain administrative or recordkeeping tasks, including failing to furnish a copy of the return to the taxpayer, failing to sign the return, failing to furnish an identifying number, and failure to retain a copy or a list of the returns he or she prepared.

- Monetary penalties against others associated with tax reporting, including tax advisors:
    - Section 6700 (promoting abusive tax shelters) – A penalty can generally be imposed on anyone who organizes, or assists in organizing, an entity, plan, or arrangement when that person makes or furnishes a statement regarding tax effects of that entity, plan, or arrangement which that person knows or has reason to know is false or fraudulent.
    - Section 6701 (aiding or abetting in tax liability understatement) – A penalty can generally be imposed on anyone who aids or assists with a return, claim, or other document when knowing that it will be used in connection with a material matter under the internal revenue laws, in such a way as to understate the tax liability of another person.

- Action to enjoin tax return preparers and advisors:
    - Section 7407 (enjoin tax preparation) – A tax return preparer can be enjoined from engaging in improper behavior that interferes with the proper administration of the internal revenue laws, and can be enjoined from all further tax return preparation if the improper behavior has been continual and repeated.

- Section 7408 (enjoin conduct related to tax shelters and reportable transactions) – A tax advisor can be enjoined from engaging in conduct which is subject to certain penalties related to tax shelters or reportable transactions or in violation of Circular 230.

- Restrictions against disclosure or use of information furnished for the purpose of preparing a tax return:

  - Section 7216 (confidentiality and use of taxpayer information) –Persons or entities who prepare returns or provide services in connection with preparing returns (e.g. tax preparation software provider) are prohibited, without prior written consent of a taxpayer, to disclose or use for another purpose information that is received to prepare the return. Failure to adhere to the prohibition can result in a criminal misdemeanor conviction with a prison sentence of up to one year and/or a fine of up to $1,000.
  - Section 6713 (improper disclosure of taxpayer information) – A civil penalty can also be imposed for the disclosure or use of tax return information without the prior written consent of an individual taxpayer, as described above.

- State taxing authority penalties.

- Treasury Department Circular N0. 230 – Section 330 of Title 31 authorizes the Department of Treasury to regulate those persons who practice before the IRS:

  - The administration of Circular 230 has been delegated to the IRS the Office of Professional Responsibility (OPR).
  - Circular 230 establishes a code of professional conduct for representing clients before the IRS, including rules for written tax advice.
  - The regulations authorize OPR to sanction, including through censure, suspension, disbarment, and monetary sanctions, those who violate designated provisions.

- Currently, the scope of Circular 230's jurisdiction is limited to attorneys, CPAs, enrolled agents, enrolled actuaries and enrolled retirement plan agents. IRS Commissioner Shulman has promised by the end of the year to recommend a new regulatory regime to oversee all tax preparers.

2. AICPA Code of Conduct and bylaws

AICPA members are required to comply with the AICPA Code of Professional Conduct. The code requires independence, integrity and objectivity. It includes rules that require members to comply with professional standards and rules related to responsibilities to clients that require confidentiality and regulate contingent fees. The code also contains rules related to other responsibilities and practices that prohibit a member from performing an act discreditable to the profession; prohibit misleading, false or deceptive advertising; regulates commissions and referral fees and requires disclosure of such fees when permitted; and regulates the form of organization a member may use as well as the use of CPA firm names. AICPA members are also required to comply with rules specifically directed at a tax practice.

In addition, the AICPA bylaws provides for disciplinary action without a hearing if a member is convicted of a crime punishable by more than one year in prison or is convicted of a crime related to various matters related to taxes. That bylaw section also provides for disciplinary action without a hearing if a member is disciplined by a state board of accountancy or by a regulatory authority that has been approved for such purpose by the Professional Ethics Executive Committee and AICPA Board of Directors.

The sanctions that may be imposed by the AICPA include admonishment, suspension or termination of membership. All such actions are published by the AICPA on its public website and in *The Wall Street Journal*.

In conclusion, the AICPA supports the concept of a CFPA and the goal of enhancing public protection for consumers of financial services, closing gaps in current regulations, and targeting those who use unscrupulous practices to prey on consumers. However, we do believe there are unintended and negative consequence of going beyond the selling of products related to consumer credit and finance and impacting services provided in the context of a CPA's professional advisory and client relationships.

The CPA profession is currently heavily and effectively regulated with regard to protecting consumers. Not exempting CPAs providing customary and usual services to their clients from the scope of this bill will drain necessary resources from the agency, as well as increasing costs to consumers without any corresponding benefit.

Thank you for the opportunity to testify on this important issue.

U.S. House of Representatives Committee on Small Business Hearing
September 23, 2009
"The Impact of Financial Regulatory Restructuring on Small Businesses and Community Lenders"

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Introduction

Chairwoman Velazquez, Ranking Member Graves, and members of the Committee, my name is Trevor Loy and I am the founder and a general partner of Flywheel Ventures, a venture capital firm based in Santa Fe, New Mexico with offices in Albuquerque and San Francisco. Flywheel invests in seed and early stage companies based on innovations in information technology and the physical sciences. We invest primarily in the Southwest and Rocky Mountain regions of the US in companies targeting global markets in digital services, physical infrastructure, energy and water. Since raising our first fund in 2002, we have grown our firm to approximately $40 million dollars across 3 active funds with investments in nearly 30 small businesses. Like most venture capital firms, however, we remain a small business ourselves. We are a team of six full-time, gender- and culturally-diverse staff members who operate on a total annual budget well below $1 million.

Our firm typically invests rounds of $100,000 to $1 million into private, start-up companies which are often built around innovations developed at the region's research universities, R&D organizations and national laboratories. We also provide a great deal of day-to-day assistance to these nascent companies. Over 80% of our investments are made in companies that have not yet completed their initial product, and do not yet have any revenue. Often, we partner with the founding entrepreneurs in setting up the company from the very beginning. These companies are quintessential small businesses. Like all small businesses, they are launched by heroic entrepreneurs with a remarkable tolerance for risk, uncertainty, and creativity. Like all small businesses, they soon hire additional employees, but constantly face daily and monthly challenges meeting payroll and other cash flow requirements, as well as competitive threats from larger domestic and overseas competitors. Like all small businesses, they pursue opportunities without allowing their lack of initial resources to limit their ideas, their plans, and their dreams. We provide financing and assistance to these entrepreneurial heroes – these small businesses with big ideas and big dreams – with a simple agenda. Our goal is for these companies to turn their ideas into products that solve real problems, then turn those products into revenues, then grow those revenues into a sustainable business that supports the careers and lives of hundreds or thousands (and once in awhile, hundreds of thousands) of employees. Eventually, the very best – and the relatively few – of the small businesses we assist become viable, market leading public companies or are acquired by larger companies so that their technologies can reach millions of people.

In addition to my responsibilities as a venture investor, I am also a member of the Board of Directors of the National Venture Capital Association (the NVCA) based in Arlington, Virginia. The NVCA represents the interests of more than 400 venture capital firms in the United States which comprise more than 90 percent of the venture industry's capital under management.

It is my privilege to be here today to share with you, on behalf of the industry, the role of venture capital investment in funding and nurturing small businesses as well as our role in the world financial system, particularly as it relates to systemic risk. Our asset class is unique in many ways, with a critical distinction being that while the start-up companies we have funded have had a proven and profound positive impact on the U.S. economy in terms of job creation and innovation, the venture capital industry itself remains a small cottage industry that poses little, if any, risk to the overall financial system.

As Congress and the Administration examine the forces that led to the financial markets crisis, including regulatory weaknesses that may have slowed an earlier response by the government, we appreciate the opportunity to be part of the discussion. Our goal is that the role of the venture capital industry in the economy be clearly understood so that we do not get swept into "one-size-fits-all" regulation intended and designed for other asset classes. Our concern is that such regulation will be an undue and unnecessary burden for venture capital firms, which are small businesses themselves. To the extent that we are burdened with the cost, time, and needless distraction of the full array of obligations required under current "one-size-fits-all" SEC registration rules, our ability to fund new companies and help entrepreneurs grow their exciting small businesses will be significantly compromised.

We remain in favor of transparency and appreciate the opportunity to offer recommendations on how regulators can meet their goals by expanding information channels already utilized by venture firms, while also protecting the continued ability of venture firms to create companies and grow jobs for the US economy.

The Fundamentals of Venture Capital Investment

I would like to begin with a brief overview of the structure and dynamics of venture capital investing. Our industry is small in terms of numbers and large in terms of positive economic impact. There are an estimated 880 venture firms in the United States; the average size of a firm is 8.5 professionals. As an industry, we manage under $200 billion dollars which is a fraction of what is managed by our private equity and hedge fund brethrens.

Venture capital funds typically are organized as private limited partnerships. Generally, 95 to 99 percent of capital for the venture fund is provided by qualified institutional investors such as pension funds, universities and endowments, private foundations, and to a lesser extent, high net worth individuals. These investors, referred to as the limited partners (LPs), generally seek the high risk/high reward exposure afforded by venture capital as a relatively small component of a diversified investment portfolio. The venture capitalists that make investment decisions on behalf of the fund collectively form the general partnership (the GP), and we supply the rest of the capital for the fund from our own personal assets. Importantly, the capital supplied to a venture capital fund consists entirely of equity commitments provided as cash from investors in installments on an as-needed basis over a period of ten or more years. Venture capital funds may occasionally borrow on a short term basis immediately preceding the time when the cash installments are due from the investors in the fund. However, venture capital funds are typically prohibited from using debt to make investments in excess of the partner's capital commitments or "lever up" the fund in a manner that would expose the fund to losses in excess of the committed capital or that would result in losses to counter parties requiring a rescue infusion from the government.

A venture fund is typically structured with a fixed term of at least 10 years, sometimes extending to 12 or more years. At the outset a limited partner commits a fixed dollar amount to the fund, but does not provide the actual investment dollars up front. The cash remains in the LPs' control until the venture capitalist has identified a company or idea in which to invest. The "capital calls" for investments generally happen in cycles over the full life of the fund on an "as needed" basis as multiple rounds of investment are made into the portfolio companies. As portfolio company investments are sold in the later years of the fund - when the company has grown so that it can access the public markets through an initial public offering (an IPO) or when it has become attractive and sustainable enough to be purchased by a larger company- the liquidity from these "exits" is distributed back to the limited partners. The timing of these distributions is subject to the discretion of the general partner, and limited partners may not otherwise withdraw capital during the entire life of the venture fund.

Once the venture fund is formed, our job is to find the most promising, innovative ideas, entrepreneurs, and companies that have the potential to grow exponentially with the application of our expertise and venture capital investment. Often these companies are formed from ideas and entrepreneurs that come out of university and government laboratories – or even someone's garage. More often than not, at the time we invest, the employee count of the business is in the single digits. Typically, the venture industry has focused on high technology areas such as information technology, life sciences, and more recently, clean technology. Some of our recent investments at Flywheel include MIOX Corporation and Tred Displays, both based in Albuquerque, New Mexico. MIOX solves one of the world's most pressing problems, the need for clean and safe water. MIOX's patented technology purifies water beyond EPA standards in over 1,300 installations around the world. The advantage of MIOX's solution, which was originally developed with funding from Los Alamos National Laboratory, is eliminating chlorine and all other dangerous and costly chemicals from the water purification process. Tred Displays is another company in Flywheel's portfolio. Much of the world's printed signage is now changing to digital technologies such as LED or LCD displays, both of which are expensive and consume tremendous energy. The Tred sign provides similar digital capability with its proprietary innovative technology that uses batteries or solar cell energy to power digital content, cutting the energy consumption of a digital sign by more than 95%.

Once we have identified a promising opportunity, we vet the entrepreneurs and conduct due diligence research on the company, the market, the financial projections and other areas. For those companies who clear this investigation, we make an investment in exchange for equity ownership in the business. Importantly, investments into start-up companies are structured as cash in return for an equity share of the company's stock. Leverage is not part of the equation because start-ups do not typically have the ability to sustain debt interest payments and often do not have collateral that lenders desire. We also generally take a seat on the company's board of directors and work very closely with management to build the company. In conjunction with searching for new businesses in which to invest, nurturing our companies is how we spend the majority of our time.

We expect to hold a typical venture capital investment in an individual company for at least 5 - 10 years, often longer and, since the technology bubble burst, rarely much less. During that time we continue to invest additional capital into those companies that are performing well; we cease follow-on investments into companies that do not reach their agreed upon milestones. Our ultimate goal is what we refer to as an exit – which is when the company is strong enough to either go public on a stock market exchange or become acquired by a strategic buyer at a price that ideally exceeds our investment. At that juncture, the venture capitalist "exits" the investment, though the business continues to grow, and the employees may continue their careers at the business for years. Essentially we make way for new investors who may be the public (when the company issues an IPO) or a new corporate owner (when there is an acquisition). The nature of our industry is that many companies do not survive, yet a few companies that end up realizing their dreams are able to generate very significant returns, and those returns effectively pay for the money we lose when, much of the time, the small business does not ultimately succeed.

Our industry is no stranger to technological and entrepreneurial risk. At least one third of our companies ultimately fail, and those that succeed usually take 5-10 years to do so. In many ways, our industry is one of the only asset classes with the long-term patience and fortitude to withstand the high rates of failure among start-up businesses. This high tolerance for risk, however, is limited entirely to the operational success or failure of the start-ups in which we are owners. This risk is very different from the systemic risk that is the basis for the recent SEC registration proposals. Because there is typically no leverage component between the VC fund and its outside investors or between the VC fund and the companies in which we invest, venture capital investment risk is contained and measured. Those portfolio companies that succeed do so in significant ways, counterbalancing the losses elsewhere in the portfolio, while losses do not compound beyond the amount of capital committed by each partner. The venture industry has operated under this risk-reward model for the last 40 years.

The Economic Contribution of Venture Capital

Historically, venture capital has differentiated the US economy from all others across the globe. Since the 1970's, the venture capital community has served as a builder of businesses, a creator of jobs, and a catalyst for innovation in the United States. According to a 2009 study conducted by econometrics firm IHS Global Insight, companies that were started with venture capital since 1970 accounted in 2008 for 12.1 million jobs (or 11 percent of private sector employment) and $2.9 trillion in revenues in the United States in 2008. Such companies include historic innovators such as Genentech, Intel, FedEx, Microsoft, Google, Amgen and Apple – all of which were once small businesses.

Our asset class has been recognized for building entire industries including the biotechnology, semiconductor, online retailing and software sectors. Within the last year, the venture industry has also committed itself to funding companies in the clean technology arena which includes renewable energy, power management, recycling, water purification, and conservation. My partners and I are extremely proud of the work that we do each day, because we are creating long term value for our investors, our companies, their employees, and the communities in which our companies operate. In fact, a 2007 study by the NVCA found that New Mexico was the fastest growing venture capital economy in the country in the past decade – and because New Mexico has a "minority-majority" population demographic, our state's rapid venture capital investment growth has brought jobs and broad economic benefits to a particularly culturally-diverse population. More broadly, we and our peers in the venture capital industry are also dedicated to playing an important role in our country's economic recovery.

Venture Capital and Lack of Systemic Risk

In light of the financial meltdowns of the past year, we believe that Congress has a right and duty to examine regulatory policy to protect investors from systemic risk. However, the venture capital industry's activities – investing and growing small, private companies over a period of 5 to 10 years -- are not interwoven with U.S. financial markets. We believe an examination of any of the measures of size, complexity or interconnection reveals that venture capital investment does not qualify as posing such risk for the following reasons:

Venture capital firms are not interdependent with the world financial system. We do not trade in the public markets. Most venture capital funds restrict or prohibit: (i) investments in publicly traded securities; (ii) investor redemptions prior to the end of the fund's term (which, in most cases, is ten to twelve years); and (iii) short selling or other high risk trading strategies. Moreover, our firm stakeholders are contained to a defined set of limited partners and their interests in the funds are not publicly traded. LPs make their investment in a venture fund with the full knowledge that they generally cannot withdraw their money or change their commitment to provide funds. Essentially they agree to "lock-up" their money for the life of the fund, generally 10 or more years as I stated earlier. This long-term commitment is critical to ensure that funds are available not just for the initial investment into a start-up, but also for the follow-on rounds of investment which provide the company continued resources to grow. LPs agree to this lack of liquidity because the venture industry has historically achieved higher returns than the public markets. However, the length and risk profile of the investment also means that LPs typically limit the amount of money that is dedicated to venture activity. A pension fund, for example, typically will only invest 5-15% of its investable assets in what are called alternative assets – the broad category of hedge fund, private equity, real estate and venture capital investments. The percentage or component of that allocation that is then committed to venture investing is often quite small.

Whereas a hedge fund in distress may leave a chain of unsettled transactions and other liabilities, a venture capital fund in distress would generally only have consequences limited to the investors' returns, the fund sponsor's inability to raise a subsequent fund, and the fund's portfolio companies potentially losing access to additional equity capital. With its relatively small allocation to venture, the totality of the capital at risk is known and transparent, bounded by the level of capital initially committed.

The venture capital industry is small in size. While certain pooled investment funds may present a systemic risk due in part to their size, the same cannot be said about venture capital funds, as the collective venture industry equates to a fraction of other alternative asset classes. In 2008, U.S. venture capital funds held approximately $197.3 billion in aggregate assets. That same year, U.S. hedge funds held, in the aggregate, approximately $1.3 trillion in assets[1]. From the period 2004 to 2008, only thirteen (13) United States venture capital funds had $1 billion or more in commitments. In comparison, approximately 218 U.S. hedge funds held over $1 billion in assets in 2008 alone. In 2008, venture capitalists invested just $28 billion into start-up companies which

[1] *See* Hedge Fund Intelligence Ltd., *United States: the end of an era? Global Review 2009*, GLOBAL REVIEW 2009 (January 2009) (available at http://www.hedgefundintelligence.com/Article.aspx?Task=Report&IssueID=71697&ArticleID=2186589).

equates to less than 0.2 percent of US GDP. The average size of a venture capital fund in 2008 was $144 million dollars.

Venture capital firms do not use long term leverage or rely on short term funding. Borrowing at the venture capital fund level, if done at all, typically is only used for short term capital needs (pending drawdown of capital from its partners) and does not exceed 90 days. In fact, many venture capital funds significantly limit borrowing such that all outstanding capital borrowed by the fund, together with guarantees of portfolio company indebtedness, does not exceed the lesser of (i) 10-15% of total limited partner commitments to the fund and (ii) undrawn limited partner commitments. Additionally, venture capital firms do not generally rely on short-term funding. In fact, quite the opposite is true. Our firms gradually call down equity capital commitments from investors over a period of approximately ten years on a "just-in-time basis", with initial investments in a company typically made within the first three to five years.

All risk is contained within the venture ecosystem of limited partners, venture capital funds and portfolio companies. This ecosystem differs significantly from others where leverage and or securitization or derivatives are used. For example, a million dollar mortgage can create a multiple of asset flows – perhaps $ 100 million – because of derivatives and bets regarding interest rates for that mortgage pool. In our world, a million dollar investment is just that – a million dollars. There is no multiplier effect because there are no side bets or other unmonitored securities based on our transaction. When one of our companies fails the jobs may go away and our million dollars is gone but the losses end there. Even when certain industries broadly collapsed in the past – such as the optical equipment industry – the failure and losses remained contained to that industry and those investments. Although entrepreneurs and their companies were impacted, the impact remained a very isolated, non systemic exposure. Without the layer of securities or use of derivatives that were at the heart of the many problematic transactions that catalyzed the recent financial crisis, the financial pain of failure remains self contained. No outside parties are betting on the success or failure of the venture industry and therefore they can not be impacted.

Risk is indeed at the heart of the venture industry but it is entrepreneurial and technological risk not systemic financial risk. Indeed, it is critical that our country proactively support this entrepreneurial risk as it has translated into the creation and growth of small businesses, millions of jobs and countless innovations that would otherwise never be brought to life. As the fundamentals of our industry are expected to remain unchanged going forward, we do not believe that we will find ourselves in a position to contribute to any systemic risk going forward.

Meeting the Need for Transparency

As I stated at the outset, we do recognize the need for transparency into our activities and, in that spirit, venture firms have provided information to the SEC for decades. We also understand the concern expressed by the Administration that the financial system overhaul must protect against what has been called "regulatory arbitrage"—where industries seek to exploit regulatory gaps.

However, we strongly believe the information we provide with slight modifications could easily be sufficient to meet these needs *without* burdening our firms with additional regulations that do not further the understanding of systemic risk. I would like to take a moment to review our current disclosure activities.

As limited partnership interests are securities, venture capital fund offerings must either be registered with the SEC or meet an exemption from registration proscribed by the Securities Act of 1933 (the Securities Act). Venture capital funds typically rely on the Rule 506 "safe harbor" of Regulation D, as an exemption from publicly registering their securities with the Securities and Exchange Commission (the SEC).

To comply with the Rule 506 safe harbor, most venture capital funds file a "Form D" disclosure document with the SEC during or shortly after their offering has commenced. The Form D requires disclosure of significant information about the private offering.

An initial Form D must be filed with the SEC no later than fifteen calendar days after the "date of first sale" of securities in the venture capital fund's offering. Any information contained in a Form D filing is publicly available. As part of the current Form D filing requirements, venture capital funds are required to disclose many aspects of their business that can assist the government in assessing whether or not the venture capital fund imposes any systemic risk to the financial system.

Form D currently requires venture capital funds to disclose information about the fund, including (i) the fund's name, (ii) principal place of business, (iii) year and jurisdiction of organization, and (iv) the form of legal entity. Form D also requires venture capital funds to disclose material information regarding the size and terms of the offering. This information includes (i) the date of first sale of the fund's securities, (ii) the intended duration of the fund's private offering, (iii) the minimum investment amount accepted from a third party investor, and (iv) the total number of accredited and non-accredited investors to which the fund has sold securities (a Form D amendment is required if the total number of non-accredited investors increases to more than 35). This information also discloses the relevant Securities Act and Investment Company Act of 1940 exemptions that the fund relies upon in privately offering its securities.

A venture capital fund must also disclose the total dollar amount of securities the fund is offering. In contrast to hedge funds and some other types of pooled investment funds, a venture capital fund offering is generally neither continuous nor for an indefinite amount of interests. The stated offering amount is also often disclosed in the venture capital fund's offering memorandum or in the limited partnership agreement among the limited partners and general partner of the fund.

While we believe the Form D filing to be sufficient to determine the lack of systemic risk from venture capital firms, we would be open to exploring ways in which we can use this filing process to provide enhanced information that would provide greater comfort to regulators. For example, question 4 on Form D currently asks the type of fund being raised, with options listed as "venture capital," "private equity fund," "hedge fund," or "other." If the VC box is selected, we could then file, on an annual basis, a supplemental form – call it D-2 – that answers the administration's questions on use of leverage, assets under management, trading positions and counterparty obligations. For VCs this would be an easy form to file since we do not use leverage, don't have counterparty obligations, and only have trading positions if we are lucky enough to have a company that has just successfully completed an IPO and we have not yet been released from the post-IPO lock-up to sell that stock. Nevertheless, it would accomplish the Administration's stated goals of providing transparency and eliminating regulatory gaps.

Increasing the disclosure on Form D, and making the additional disclosure an annual requirement, would be a viable option and would serve the regulators well without unnecessarily burdening the venture firms as SEC registration would do.

Additional SEC Registration Requirements Could Hamper Venture Activity

The SEC previously used the Investment Advisers Act of 1940 (the Advisers Act) as a mechanism to attempt to regulate hedge fund activity. It is important to note that the SEC also explicitly exempted venture capital activity from that regulatory push. We strongly believe that the government's need to understand the venture industry's financial commitments can be met with disclosure channels as we've described. Using the Advisers Act brings layers of additional regulatory requirements that can prevent us from focusing our time and financial resources on helping to start and grow new companies, does not provide the government with meaningful insight into systemic risk assessment and will divert government resources. Although government officials have attempted to portray this registration as simply filling out a form, that is not the case. The additional obligations required of a registered investment adviser are complex, costly, and most certainly burdensome.

A venture capital firm employs a small administrative staff to handle firm operations. Often an investing partner will take on the role of Chief Administrative Officer and in that capacity will manage a Chief Financial Officer. The CFO is fully engaged in the financial operations of the firm, including portfolio company reporting, and all investor relations activities. At Flywheel, the role of Chief Administrative Officer is handled by my colleague Mrs. Kim Sanchez Rael, a native New Mexican who is also a full investment partner in our firm. Mrs. Rael oversees our single full-time Director of Finance and Operations. This individual, Mrs. Paula Segura Marez, is a native of rural New Mexico who I now proudly note has been honored as one of the top CFO's in our region. She manages all aspects of our quarterly and annual financial reporting, our portfolio company reporting, our relationships with our tax, audit, accounting and legal service providers, our investor relations, our capital management and other miscellaneous financial activities. In addition, as a small firm, her responsibilities encompass general management and office management duties, including seemingly mundane activities such as booking travel, filing expense reports, and coordinating team logistics. By requiring venture funds to ***register*** with the SEC under the current Advisers Act, the administrative burden on the firm and the CFO would grow exponentially. In addition to filing information regarding the identification of the firm, its partners and assets under management, the Advisers Act establishes a number of substantive requirements that would change the operation of a venture fund and the relationship between the venture fund and its limited partners. Many of these requirements, which are summarized below, would demand significant resources and overhead which sophisticated investors have not requested and venture funds currently do not have in place.

SEC Examinations -- The SEC can and does conduct periodic examinations of registered investment advisers. The SEC inspection staff looks closely at, among other things, the firm's internal controls, compliance policies and procedures, annual review documentation and books and records. SEC examinations may last anywhere from a few days to a few months. The intent of these inspections is to evaluate the firm's compliance with various policies and procedures imposed on registered advisers. We do not believe that requiring periodic inspections of venture capital firms would provide meaningful insight for the government's assessment of systemic risk; however, we do believe it would further divert the SEC's resources from inspection of firms that do present systemic risk. Moreover, the costs and administrative burdens associated with preparing for an examination can be substantial.

Performance Fees: The Advisers Act prohibits contracts that provide for compensation based on a percentage of the capital gains or capital appreciation in a client's account, subject to certain exceptions, including a provision that permits a performance fee to be charged to certain "qualified clients" of the adviser that have a minimum net worth or a minimum amount of assets under management with the adviser. This limitation was designed to preclude advisers from subjecting client funds and securities to unnecessary speculation in order to increase fees to the adviser. However, venture firms are intentionally structured to make investments in companies that may fail and requiring venture firms to register could unintentionally prohibit carried interest payments for certain investors, thereby denying them access to a high-growth alternative asset class. In particular, it would require significant restructuring issues for existing funds formed in reliance on existing exemptions. More fundamentally this restriction alters the long-standing practice of LPs providing increased incentives for the GP to demonstrate long-term commitment to company growth. Doing so could change the dynamics of the industry unnecessarily.

The following administrative requirements, while not controversial, would require venture firms to dedicate resources beyond those which their investors have asked them to devote:

***Compliance Programs and Appointment of Chief Compliance Officer*:** The Advisers Act would require venture firms to implement written policies and procedures designed to prevent violations of the federal securities laws, to review the policies and procedures annually for their adequacy and the effectiveness of their implementation, and to designate a chief compliance officer (a "CCO") to be responsible for administering the policies and procedures. The CCO selected by the venture firm must be competent and knowledgeable regarding the Advisers Act and should be empowered with full responsibility and authority to develop and enforce appropriate policies and procedures for the firm. The SEC has indicated that it expects that written policies and procedures would address, at a minimum (i) portfolio management processes; (ii) trading practices; (iii) proprietary trading of the adviser and personal trading by the adviser's supervised persons; (iv) accuracy of disclosures made to clients, investors and regulators; (v) safeguarding of client assets; (vi) accurate creation and maintenance of required books and records; (vii) advertising and marketing practices; (viii) processes to value client holdings and assess fees based on those valuations; (ix) safeguards for the privacy protection of client records and information; (x) disaster recovery and business continuity plans; (xi) insider trading safeguards; and (xii) anti-money laundering efforts.

Codes of Ethics: The Advisers Act would require venture firms to adopt a code of ethics (a Code) which must set forth, among other things, (i) standards of conduct expected of personnel; (ii) a system of pre-clearance for investments in initial public offerings and private placements (iii) a requirement that all violations of the Code be promptly reported to the CCO or his or her designee; and (iv) a requirement that certain advisory personnel periodically report their personal securities transactions and holdings in securities. As venture capital funds do not typically trade in the public markets and generally limit advisory activities to the purchase and sale of securities of private operating companies in private transactions, the latter requirement is of limited relevance to venture capital funds, yet would still apply.

Reports in relation to securities holdings must be submitted to CCO on an annual basis; reports in relation to securities transactions must be submitted on a quarterly basis. The adviser must provide each supervised person with a copy of its Code and must obtain each supervised person's written acknowledgement of receipt of the Code, as well as any amendments.

Form ADV and Periodic Filing: The Advisers Act would require a venture firm to file Form ADV Part I with the SEC in order to become registered under the Advisers Act. In addition, all registered venture firms would need to furnish each limited partner or prospective limited partner with a written disclosure statement that provides information concerning the venture firm, its operations, and its principals. This would need to be done on at least an annual basis.

Custody: The Advisers Act would require a venture firm that has custody of limited partner funds or securities to maintain such funds or securities with a qualified custodian. If a venture firm has custody of the limited partner funds or securities, then the firm must send quarterly account statements directly to each limited partner, member or other beneficial owner. However, the venture fund need not send these quarterly account statements if such entity is subject to audit at least annually and distributes audited financial statements to all limited partners. In the alternative, a venture firm possessing custody may also have an independent public accountant verify the assets held by the firm at least once a year. This auditing procedure must be conducted on a surprise, rather than a scheduled, basis.

Recordkeeping: The Advisers Act sets forth the books and records investment advisers must maintain. The CCO and at least one member of the professional staff of a venture firm would have to be fully familiar with this rule, which lists approximately 20 categories of records to be maintained, and with all operating procedures for complying with the recordkeeping rule. Generally, a registered investment adviser's books and records must be kept for a total period of five years (and longer in some cases).

All of these compliance elements promise to be costly from both a financial and human resources perspective. They also promise to change the way venture capital firms operate, adding significant administrative burden in exchange for information that is neither relevant nor useful for measuring and managing systemic risk. Most importantly, these regulatory requirements will take resources away from our most important job – building businesses.

We have been in this place several times before. In 2001, then President Bush signed into law the USA Patriot Act, broad legislation intended to combat terrorism and money laundering activity. The legislation imposed anti-money laundering ("AML") compliance obligations on "financial institutions," including broker-dealers, commodity trading advisors, commodity pool operators and investment companies. While the term "investment companies" was not specifically defined, most legal opinions concluded that the term was intended to encompass both registered investment companies (e.g., mutual funds) and private investment funds (e.g., U.S. and offshore unregistered hedge funds, funds-of-funds, commodity pools, private equity funds and venture capital funds).

In addition to complying with existing AML requirements such as reporting currency transactions and complying with the economic sanctions imposed by the U.S. through the Office of Foreign Assets Control ("OFAC"), the new statute imposed significant new obligations, including designating a compliance officer, establishing ongoing training programs and arranging independent audits to ensure compliance.

However, as the regulatory process unfolded, the Treasury Department ultimately recognized that venture activity did not meet the criteria for money laundering risk. The Treasury concluded that funds which do not permit investors to redeem investments within two years of their purchase would not be required to comply with the USA Patriot Act's AML compliance program obligations. In this instance the regulations were tailored to meet the need for information and transparency while not affecting activity ultimately unrelated.

If Congress is not able to protect venture capital investment and we are swept into the regulation, the consequences are likely to mirror those of the Sarbanes Oxley Act when regulation was applied to companies of all sizes though intended to curb the abuses at the largest public firms. As this committee well knows, since Sarbanes Oxley was passed, small companies have been burdened with millions of dollars of compliance costs and countless hours dedicated to regulatory activities. Theses resources, if put towards growth activities would have produced tremendous value which is forever lost. Eight years later, despite continued pressure from this Committee, despite numerous SEC "reviews" of the costs of SOX to small companies and despite numerous delays, the SEC still has not permanently addressed this problem. Given this track record, our skepticism is perhaps understandable that the SEC will in fact implement its registration regulation in a way that matches obligations to risk. We urge Congress to strongly consider the unintended consequences of financial reform on small businesses now rather than later. The start-up community can not afford another Sarbanes Oxley.

Summary

We understand that the implosion which occurred in the financial system in the last year – and the economic strife which ensued – provides an understandable and justifiable reason to examine how to better protect investors and the overall market. We agree that those entities and industries which could cause financial system failure should be better monitored so that the events of 2008 are never repeated. However, venture capital is not one of those industries. Our size and operations within the private market do not pose broader financial risk. Venture capital played no role in the recent financial meltdown and does not have the fundamental investing principles to cause a future financial system failure. By requiring the venture industry to comply with the requirements of the Advisers Act, Congress would be unfairly and unnecessarily weighing down an asset class that should be focused on building businesses and creating jobs, rather than re-directing our resources and time toward administrative functions that our investors did not request and that do not help the entrepreneurs that we fund to create valuable businesses and the jobs that follow.

For innovation and entrepreneurship to continue to succeed in the US, the venture capital industry needs a supportive public policy environment. In many areas we acknowledge and are thankful for a public policy framework in the US that not only supports our industry and our entrepreneurs but remains the envy of the rest of the world. This committee, in particular, has been supportive of policies that allow us to do our jobs better and more effectively. As a small and dynamic industry, however, we remain highly susceptible to seemingly minor changes in our ecosystem. While some larger asset classes may be able to absorb the proposed regulatory costs and requirements, I am here today to say that the venture industry – and subsequently the start-up economy – will not go unscathed by the contemplated regulatory changes. We ask that Congress examine each asset class that will be impacted by this legislation and make your policy decision based upon the systemic risk posed by each as well as the implications of regulation, and focus the government's resources where it can have the most impact. We believe you will come to the same conclusion: venture capital does not belong in this mix. I thank you for your consideration today and I am happy to answer any questions.

Statement of the U.S. Chamber of Commerce

ON: THE IMPACT OF FINANCIAL REGULATORY RESTRUCTURING ON SMALL BUSINESSES AND COMMUNITY LENDERS

TO: THE U.S. HOUSE COMMITTEE ON SMALL BUSINESS

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The Chamber's mission is to advance human progress through an economic, political and social system based on individual freedom, incentive, initiative, opportunity and responsibility.

The U.S. Chamber of Commerce is the world's largest business federation, representing more than three million businesses and organizations of every size, sector, and region.

More than 96 percent of the Chamber's members are small businesses with 100 or fewer employees, 70 percent of which have 10 or fewer employees. Yet, virtually all of the nation's largest companies are also active members. We are particularly cognizant of the problems of smaller businesses, as well as issues facing the business community at large.

Besides representing a cross-section of the American business community in terms of number of employees, the Chamber represents a wide management spectrum by type of business and location. Each major classification of American business -- manufacturing, retailing, services, construction, wholesaling, and finance -- is represented. Also, the Chamber has substantial membership in all 50 states.

The Chamber's international reach is substantial as well. It believes that global interdependence provides an opportunity, not a threat. In addition to the U.S. Chamber of Commerce's 112 American Chambers of Commerce abroad, an increasing number of members are engaged in the export and import of both goods and services and have ongoing investment activities. The Chamber favors strengthened international competitiveness and opposes artificial U.S. and foreign barriers to international business.

Positions on national issues are developed by a cross-section of Chamber members serving on committees, subcommittees, and task forces. More than 1,000 business people participate in this process.

Chairman Velazquez, Ranking Member Graves, and Members of the Committee on Small Business, thank you for the opportunity to speak before you today about an issue of great concern to our members: the impact of financial regulatory restructuring on small businesses and community lenders.

The U.S. Chamber is the world's largest business federation, representing more than 3 million businesses and organizations of every size, sector, and region. More than 96 percent of the Chamber's members are small businesses with 100 or fewer employees, 70 percent of which have 10 or fewer employees. Each major classification of American business – manufacturing, retailing, services, construction, wholesaling, and finance – is represented. Furthermore, the Chamber has substantial membership in all 50 states.

I'd like to begin my statement by stating clearly that the U.S. Chamber supports the Administration's goal of enhancing consumer protections. In fact, the Center for Capital Markets Competitiveness has been calling for regulatory reform that includes strong consumer protections since before the financial crisis. The financial crisis, however, certainly shined a light on the weaknesses and shortcomings of our outdated regulatory system, and millions of consumers and investors were harmed due, in part, to regulatory failures. Consumers need clearer disclosure and better information. They also need vigorous enforcement against predatory practices and other consumer frauds.

We oppose H.R. 3126, the Consumer Financial Protection Agency Act of 2009, because we believe it is the wrong way to enhance consumer protections and will have significant and harmful unintended consequences for consumers, for the business community, and for the overall economy.

We are particularly concerned that these unintended consequences may fall disproportionately upon small businesses. As such, the Chamber commissioned a study to examine the CFPA and its potential effect on small business access to credit, "The Impact of the Consumer Financial Protection Agency on Small Businesses."[1] The study was authored by Thomas Durkin, an economist that spent more than 20 years at the Federal Reserve Board, serving as Senior Economist in the Division of Research and Statistics.

As we officially release the study today, I am here to provide Members of the Committee with an overview of the study and its key findings. I would also like to briefly discuss the Chamber's key concerns with regard to H.R. 3126.

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[1] The Impact of the Consumer Financial Protection Agency on Small Businesses [Hereinafter "Durkin Study".] Available at www.uschamber.com/ccmc. Embargoed until September 23rd, 2009,

Small Businesses and the Economy

As you are well aware, businesses operating at a small scale of production and employment account for a substantial portion of U.S. jobs. The 5.9 million firms with fewer than 100 employees accounted for 35% of U.S. employment in 2006[2]. In addition, small businesses play an important role in creating new jobs, keeping overall unemployment rates low, and providing an unemployment cushion when unemployment rises. In 2006, of the 800,000 businesses that created new jobs, 642,000 had fewer than 20 employees[3]. In fact, between 1987 and 2005, new firms accounted for most of the net job creation in the U.S. – 86.7% of which were start-ups with less than 20 employees.[4]

For many of these new firms, their ability to grow and create new jobs is heavily dependent upon their access to credit. Small firms typically have trouble borrowing money – either they cannot borrow, they cannot borrow as much as they need, and almost certainly cannot secure long-term financing available to larger companies. According to a Federal Reserve study[5], almost 20% of firms with fewer than 20 employees did not even apply for loans because they expected to be denied. In 2003, when the credit markets were robust relative to today, of those that did apply for credit, at least one application was denied a third of the time. Of new start-up firms, almost 25% did not apply for credit because they expected to be denied, and of those that did apply, at least one application was denied more than half of the time.

Small Businesses Use Consumer Lending Products

In understanding the impact of the proposed CFPA, it is critical to recognize that the small business sector relies most heavily on consumer financial products. Standard sources of working capital such as lines of credit are used the least by small firms. Only 42.5% of self-employed individuals have a traditional loan, increasing to 59.1% for firms with 1-4 employees. That statistic jumps to 93.8% for businesses with 100-499 employees[6].

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[2] Durkin Study citing (Employments and Payroll data from Office of Advocacy, U.S, Small Business Administration, Firm Size Data, available at http://www.sba.gov/advo/research/st_06.pdf.)

[3] Durkin Study citing (Latest Statistics (2005-2006) on the change in U.S. Business Employment are available at http://www2.census.gov/econ/susb/data/dynamic/0506/us_state_totals_emplchange_2005-2006.xls. More recent Census data on US businesses are not available.)

[4] Durkin Study citing (John Haltiwanger, Ron Jarmin and Javier Miranda, "Business Dynamics Statistics Briefing: Jobs Created from Business Startups in the United States," Ewing Marion Kauffman Foundation (January 2009), available at http://ssrn.com/abstract=1352538).

[5] Durkin Study citing (Lieu N. Hazelwood, Traci L. Mach, and John D. Wolken, "Alternative Methods of Unit Nonresponse Weighting Adjustments: An Application from the 2003 Survey of Small Business Finances," Federal Reserve Board- Finance and Economics Discussion Series, 2007-10, available at http://www.federalreserve.gov/pubs/feds/2007/200710/200710abs.html).

[6] Durkin Study citing (Table A in "Small Business and Micro Business Lending in the United States, for Data Years 2003-2004," Office of Advocacy, US Small Business Administration, November 2005)

For example, our study finds that personal credit card use is highly prevalent among small businesses as a supplement for traditional commercial lending that small businesses struggle to obtain. Additionally, Durkin cites the 2007 Survey of Consumer Finances[7] that demonstrates that self-employed individuals often rely on home equity loans – and in fact families headed by a self-employed individual (20.4%) had larger amounts of debt secured by residential property on average than families overall (12.6%). As Durkin notes, author Hernando de Soto identifies home equity loans as the "single most important source of funds for new businesses in the United States.[8]"

In addition, small businesses use consumer credit products that might be considered "fringe" financial products to meet their needs for immediate short-term capital. For example, auto title loans provide small business owners with immediate access to cash and no up-front fees or prepayment penalties – thus uniquely useful in meeting short term capital needs that will be repaid in a short timeframe. For small businesses owners, relatively higher interest rates are an acceptable cost for the utility of the title loan.

To conclude, Durkin asserts that small businesses rely extensively on consumer lending products and use them as a source of credit in very different ways than consumers. As an example, small businesses are less likely to use their credit cards on a revolving basis than regular households – in fact 70.7% of business owners with no employees pay their balances at the end of the month, compared with only 53.8% for consumers[9].

CFPA Impact on Small Business

Durkin concludes that the proposed Consumer Financial Protection Agency would result in reduced access to credit for small businesses.

First, the author states that the CFPA will likely "cause disruptions in consumer credit markets due to extensive legal uncertainty arising from provisions of the proposed Act." Specifically, the bill would apply an unclear "abusive" standard to allow the CFPA to prohibit products and practices, but there are no existing legal precedents for guidance about how to interpret "abusive." This would in turn create significant legal uncertainty regarding products and practices and their compliance with the law, creating disincentives and higher costs associated with products – particularly new products.

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[7] Durkin Study citing (Table 13 B in Brian Bucks, Arthur Kennickell, Traci Mach, and Kevin B. Moore, "Changes in U.S. Family Finances from 2004 to 2007: Evidence from the Survey of Consumer Finances," Federal Reserve Bulletin February 2009, available at http://www.federalreserve.gov/pubs/bulletin/2009/pdf/scf09.pdf.)

[8] Durkin Study citing (Hernando de Soto, *The Mystery of the Capital: Why Capitalism Triumphs in the West and Fails Everywhere Else* (Basic Books, 2003) at 6; reprinted by The New York Times, Online Edition, available at http://www.nytimes.com/books/first/d/desoto-capital.html).

[9] Durkin Study citing (Federal Reserve Board, Survey of Consumer Finance, 2007, available at http://www.federalreserve.gov/pubs/oss/oss2/scfindex.html.)

As an example of the costs associated with legal uncertainty in regulation, Durkin highlights the passage of the Truth in Lending Act (TILA) and subsequent uncertainty over its legal interpretation. Conceptually, the Truth in Lending Act is relatively simple – disclose the costs and other terms of credit in a "clear and conspicuous manner" with federal preemption of state actions in the area. However, due to legal uncertainty surrounding provisions of the legislation, a week before its effective date in 1969, there were 34 official interpretations of the regulation, by June 1979 more than 13,000 Truth-in-lending lawsuits had been filed in Federal courts (up to 50% of the caseload in some districts), and by early 1980, the Federal Reserve Board had published 1500 official interpretations with varying degrees of legal authority[10]. Despite TILA's straight-forward objective and wide support, legal uncertainty led to the expenditure of significant resources by creditors to ensure compliance.

Further, the CFPA Act gives the states, as well as localities, the authority to issue more restrictive consumer protection regulations than those adopted by the CFPA. As a result, lenders would be newly subject to varying regulations and litigation exposure across the 50 states.

Taken together, Durkin concludes that the CFPA would create considerable new risks to lenders of regulatory fines and litigation from extending credit. This would increase the cost to lenders of making credit available, and create pressure for lenders to raise prices on consumer credit products. Durkin also concludes that the CFPA would cause lenders to withdraw some credit products from the market. Lenders need to expect that revenue will exceed the expected costs of a product before it is offered, with enough of a profit to remain competitive. If increases in fees or interest rates are not enough to compensate for higher costs, the products may be pulled. In addition, the CFPA would require lenders to offer standardized products to consumers before or at the same time as the lender offers its own, alternative products. A standard, government approved product may siphon customers away from alternative products, making it unlikely the lender will continue to offer anything but the standard product.

Therefore, small businesses as users of consumer financial products, would also likely have less credit available to them at higher prices.

Small businesses need a flexible set of credit products that meet the short term fluctuations in their credit needs without a long outstanding line of credit. These factors give them a different risk profile and credit needs than a consumer, yet the CFPA adopts a one-size-fits all approach to credit products. By encouraging standardized products, the CFPA will seek to respond to the "average consumer." However, it is likely CFPA regulations will cover all

[10] Durkin Study citing (Ralph J. Rohner, ed. The Law of Truth in Lending (Boston: Warren, Gorham and Lamont, 1984). See also, Jonathan M. Landers, The Scope of Coverage of the Truth in Lending Act, American Bar Foundation Research Journal (Volume 1, Number 2, 1976) and Jonathan M. Landers and Ralph J. Rohner, "A Functional Analysis of Truth in Lending," UCLA Law Review, April, 1979.)

consumer lending products regardless of whether they are used by small businesses – small businesses that have different needs and a different risk appetite than the "average consumer."

Finally Durkin asserts that small businesses, despite not being consumers and therefore a clear target of the legislation, would face collateral damage from the CFPA. They would likely have less access to credit – not for consumption – but for building and operating their businesses. For the credit they can obtain, it will come at a higher cost. The result will be fewer start-ups and slower growth for small businesses, business closures, and importantly, a significant reduction in jobs – both by eliminating current jobs and preventing new job creation.

In sum, a new regulatory regime that adversely impacts small businesses with higher costs and new financial difficulties through unavailable products is simply the wrong remedy at the wrong time.

Key Concerns with H.R. 3126

Legislation to enhance consumer protection should focus on ensuring disclosures to consumers are transparent, understandable and concise; improving consumer education; enhancing the ability of consumers to choose between competing products whose terms are well disclosed and truthfully conveyed; and ensuring strong and consistent enforcement to deter and punish illegal and predatory activities.

Because we do not believe that the proposed Consumer Financial Protection Agency will achieve these objectives, we oppose legislation to create it.

Scope

The Chamber recently joined with 24 other trade associations representing vast sectors of the business community to express concern regarding the scope and regulatory authority of the CFPA – from advertising agencies to homebuilders to real estate service providers. The definitions included in Section 101 of the bill vastly expand the scope of the CFPA to businesses that simply extend credit to their customers – whether through accounts receivable, lay-away programs, installment plans or even a "tab" payable at the end of the month. In addition, the bill would cover any entity that provides a "material service" to a provider of consumer financial products, or that is in anyway "indirectly" engaging in a financial activity, broadly defined, with a consumer. This would include technology providers, communications, accountants, advertisers, shipping service providers, and several others.

In addition, the CFPA would have authority over all aspects of a covered entity's business practices, not just the consumer transaction. Ultimately, this will impose significant new costs on businesses for which "consumer finance" is well outside their core business. I'd like to submit the industry letter dated September 18, 2009, for the record.

Safety and Soundness vs. Product Regulation

Separating the regulation of financial products from regulatory expertise regarding the underlying financial institutions and related regulatory goals such as safety and soundness is neither pro-consumer nor effective. In fact, dividing these responsibilities will only increase the likelihood that key issues related to consumer protection will fall through the cracks – exacerbating a fundamental weakness of our current system, which is already unduly fragmented. In addition, there is no dispute mechanism in the bill to address potential conflicts when a safety and soundness regulator disagrees with a CFPA regulation – what is considered "low risk" for consumers may in fact pose significant risks to the health of the institution and the stability of the financial system.

Lack of Preemption

At a time when harmonization has been identified by all stakeholders as a goal of regulatory reform, the proposed new Agency will do exactly the opposite. Rather than adopting a new national standard and preempting multiple and conflicting state laws, the new agency would set the floor, creating inconsistencies, duplications, and conflicting mandates between the federal and state agencies. In fact, the bill even rolls back 150 years of banking law by subjecting national banks for the first time to state consumer protection mandates. Further, a separate consumer protection agency will foster uncertainty and encourage regulatory arbitrage – the same kind of arbitrage that has been widely identified as a source of regulatory failures that contributed to the crisis.

To make matters worse, the bill explicitly authorizes state attorneys' generals ("State AGs") to enforce federal mandates.

Small Institutions will be Disadvantaged

The legislation nationalizes consumer finance by requiring institutions to offer government mandated products or "plain vanilla" products. The government does not have the market insight or expertise to design financial products that respond to consumer demand at an efficient price. In addition, the CFPA would discourage many financial institutions, especially small institutions, from offering alternative products tailored to meet consumer needs. In a market dominated by a government mandated product, the legislation would give large institutions clear advantages over smaller competitors that cannot as easily absorb the additional costs of offering, marketing and distributing non-"plain vanilla" products – let alone offer them at a competitive price. For small businesses that rely heavily on their community banks for credit products, the result will be disproportionately harmful.

Federal Stamp of Approval

The government cannot, nor should it aim to, regulate risk out of financial products. Consumers benefit from having and making well informed, clear choices about which products serve their needs. While the primary goal of consumer protection regulation should be to thwart abusive practices and deter fraud, we cannot ignore the need to also encourage and facilitate consumers conducting their own due diligence in reviewing products to determine which are best for them and their appetite for risk. Putting a federal stamp of approval on consumer products only reduces such incentives by signaling that these products are safe and free from potential loss.

Another Regulatory Layer

Furthermore, H.R. 3126 adds another regulatory layer – both to existing federal agencies and to state regulation – that will inevitably stifle innovation. Consumer product providers need the ability to create new pro-consumer products, propose them to regulators, and get a timely and effective review.

Removes Important Checks on FTC's Authority

The legislation would replace the Federal Trade Commission's (FTC) rule-making authority under the Magnuson-Moss Act with the expedited processes of the Administrative Procedures Act (APA). Magnuson-Moss was intended to provide procedural protections for affected industries and other groups under the extraordinarily broad jurisdictional reach of the FTC. This provision removes an important check on FTC's rule-making authority. In addition, this would occur against the backdrop of the unprecedented and broad rule-making and civil penalty authority the legislation grants to the FTC that would enable it to regulate most industries with little oversight and no recourse for effected industries.

Unnecessary and Costly Litigation

H.R. 3126 will needlessly increase the costs and inefficiencies of private litigation by granting the CFPA authority to prohibit mandatory arbitration clauses. Arbitration has proven repeatedly to be an efficient and effective alternative to the costly and inaccessible court system. Furthermore, courts and regulators already possess and exercise broad authority to ensure the fairness of arbitration processes. In addition, Section 1042 of H.R. 3126 authorizes state attorneys' generals to sue for violations of any provisions of the bill or regulations promulgated there under.

Conclusion

Again, thank you for the opportunity to speak before you today. I look forward to working with Members of this Committee and your colleagues to craft legislation that protects consumers – but in a way that also protects economic opportunity and consumer choice.

National Association of Mortgage Brokers

Prepared Testimony of

Mike Anderson, Vice-Chairman
Government Affairs

National Association of Mortgage Brokers

on

"The Impact of Financial Regulatory Restructuring on Small Businesses and Community Lenders"

Before the

Small Business Committee

United States House of Representatives

September 23, 2009

Good morning Chairwoman Velázquez, Ranking Member Graves, and members of the Committee. I am Mike Anderson, a Certified Residential Mortgage Specialist ("CRMS") and Vice-Chairman of the Government Affairs Committee of the National Association of Mortgage Brokers ("NAMB"). I am also a practicing mortgage broker in the state of Louisiana with over 30 years of experience. Thank you for inviting me to testify today on "The Impact of Financial Regulatory Restructuring on Small Businesses and Community Lenders."

NAMB is the only national trade association that represents the mortgage broker industry. The mortgage broker industry brings greater competition to the market for origination services and often provides consumers with a local alternative to using a large national bank or lender.

Mortgage brokers are typically small businesses, employing between three and fifty employees. They serve both urban and rural communities of every size, and operate in all 50 states and the District of Columbia. Mortgage brokers work with consumers to help them through the complex mortgage origination process, and add value to that process for both consumers and lenders by serving many areas that are typically underserved by banks and other financial institutions. Because many mortgage broker businesses are established and operated exclusively within the communities they serve, they also add value to the process by providing goods, facilities, and services with quantifiable value, including a loyal customer base and goodwill.

NAMB advocates on behalf of more than 70,000 small business mortgage professionals located in all 50 states and the District of Columbia. NAMB also represents the interests of homebuyers, and advocates for public policies that serve mortgage consumers by promoting competition, facilitating homeownership, and ensuring quality service.

NAMB is committed to enhancing consumer protection and promoting the highest degree of professionalism and ethical standards for its members. NAMB requires its members to adhere to a professional code of ethics and best lending practices that fosters integrity, professionalism, and confidentiality when working with consumers. NAMB provides its members with access to professional education opportunities and offers rigorous certification programs to recognize members with the highest levels of professional knowledge and education. NAMB also serves the public directly by sponsoring consumer education programs for current and aspiring homebuyers seeking mortgage loans.

I. Introduction

On June 17, 2009, the Obama Administration released a policy paper through the Department of Treasury entitled "A New Foundation: Rebuilding Financial Supervision and Regulation." In this paper, the Administration outlines a number of proposals aimed at overhauling the structure of our nation's system of financial regulatory oversight, with a special focus on protecting consumers in the market for financial products and services.

The policy paper specifically cites the failure of our current regulatory framework to adequately protect borrowers in mortgage transactions as a critical underlying cause of our financial crisis. The Administration contends that gaps and conflicts of interest have long-existed between state and federal regulators charged with enforcement of consumer protection statutes. The paper goes on to say that consistency and strength of regulation of consumer financial products and services are primary objectives of the Administration's Financial Regulatory Reform Plan ("Administration Plan").

The Administration Plan, as outlined in the Department of Treasury policy paper, focuses on a number of significant issues. Today, our testimony will specifically address issues raised by Section III of the paper which has generally been introduced as H.R. 3126, the "Consumer Financial Protection Agency Act of 2009."

NAMB is generally supportive of the concept behind the Administration's Plan outlined in the Department of Treasury policy paper. NAMB believes that protecting consumers is critically important to rebuilding faith and confidence in our mortgage and financial markets, which has eroded over the past several years. Nevertheless, NAMB feels that any overhaul of the financial regulatory structure must adequately account for the complexity of the modern mortgage market and must endeavor to be non-discriminatory between federal and state chartered entities and focus on clarity to consumers in order to obtain better choices. A reduction in product choices for consumers each consumer situation is unique. Lastly, we believe the most important aspect of a mortgage product is being overlooked; pricing of a product should not be viewed as the ultimate objective. A mortgage with a lower rate is not better if the loan does not close when the consumer requires it to close. In every instance, a consumer cannot have a truck full of their belongings sitting for an extra week while a loan with a "lower rate" gets to the closing table. Service and reliability are factors that cannot be determined by a panel in Washington, DC, only the competitive market place can effectively screen low quality lenders out of the marketplace.

II. Consumer Financial Protection Agency

The Administration's Plan calls for the establishment of a new independent federal regulatory agency called the Consumer Financial Protection Agency ("CFPA"), which is reflected in H.R. 3126. This new agency would become the primary federal regulator focused on consumer protection in the markets for financial products and services.

Under the legislation, the CFPA would be granted rule-making authority for consumer protection under existing statutes, and would possess enforcement and supervisory authority over all persons covered by those statutes.[1] Additionally, the CFPA would be given specific authority to impose greater responsibilities on mortgage lenders, originators, and securitizers. These responsibilities would include: (1) ensuring all communications and disclosures made to consumers are reasonable; (2) offering consumers a "standard" or "plain vanilla" mortgage product option in addition to any other product options available; and (3) exercising a duty of care, possibly among other duties, when working with consumers.

NAMB believes the CFPA, or any other agency for that matter, must act prudently when promulgating and enforcing rules in order to ensure real protections are afforded to consumers, and not merely the illusion of protection that often comes from incomplete or unequal regulation of similar products, services, or providers. Although the CFPA would be given broad powers to regulate and enforce substantive standards for all "consumer financial products or services," today we will focus our testimony on its impact on the small business community, and specifically the mortgage broker industry.

III. How the Mortgage Broker Industry is Currently Regulated

Before delving into the details of the CFPA, it is essential to discuss how mortgage brokers are currently regulated under our existing financial regulatory structure. Since the inception of the mortgage broker industry, brokers have been regulated at both the state and federal levels. Like bankers and other lenders, mortgage brokers comply with every federal fair lending and housing law and regulation affecting the mortgage loan origination industry. Additionally, mortgage brokers comply with a host of state laws and regulations affecting their businesses, from which bankers and lenders are largely exempt.

Mortgage brokers are just one participant in a larger network of loan originating entities – including mortgage bankers, mortgage lenders, credit unions, and depository institutions – all competing to deliver mortgage products to consumers. In today's market, there are actually very few substantive differences between these distribution channels when it comes to originating mortgages. The lines that once divided them have become increasingly blurred with the proliferation of the secondary mortgage market, and more often mortgage brokers and mortgage lenders perform essentially the same function – i.e., they present an array of available loan products to the consumer and close the loan. The lenders, who underwrite and fund the loan, then almost instantaneously sell the loan to the secondary market.

Although mortgage brokers are typically held to higher standards in most states, and consumers often fail to distinguish one origination source from another, brokers stand singularly accused of operating on an unregulated basis. This accusation is plainly false. Mortgage brokers are regulated by more than ten federal laws, five federal enforcement agencies and at least forty-nine state regulation and licensing

[1] The statutes under which the CFPA would be granted authority include the Truth-in-Lending Act ("TILA"), Real Estate Settlement Procedures Act ("RESPA"), Home Ownership & Equity Protection Act ("HOEPA"), Equal Credit Opportunity Act ("ECOA"), Fair Debt Collection Practices Act ("FDCPA"), and Home Mortgage Disclosure Act ("HMDA").

statutes. Moreover, mortgage brokers, who typically operate as small business owners, must also comply with a number of laws and regulations governing the conduct of commercial activity within the states.

a. Federal Regulation of Mortgage Brokers

Mortgage brokers are governed by a host of federal laws and regulations. For example, mortgage brokers must comply with: the Real Estate Settlement Procedures Act ("RESPA"), the Truth in Lending Act ("TILA"), the Home Ownership and Equity Protection Act ("HOEPA"), the Fair Credit Reporting Act ("FCRA"), the Equal Credit Opportunity Act ("ECOA"), the Gramm-Leach-Bliley Act ("GLBA"), and 1 The statutes under which the CFPA would be granted authority include the Truth-in-Lending Act ("TILA"), Real Estate Settlement Procedures Act ("RESPA"), Home Ownership & Equity Protection Act ("HOEPA"), Equal Credit Opportunity Act ("ECOA"), Fair Debt Collection Practices Act ("FDCPA"), and Home Mortgage Disclosure Act ("HMDA"), the Federal Trade Commission Act ("FTC Act"), as well as state and federal fair lending and fair housing laws. Many of these statutes, coupled with their implementing regulations, provide substantive protection to borrowers who seek mortgage financing. These laws impose disclosure requirements on brokers, define high-cost loans, and contain anti-discrimination provisions.

Additionally, mortgage brokers are under the oversight of the Department of Housing and Urban Development (HUD) and the Federal Trade Commission (FTC); and to the extent their promulgated laws apply to mortgage brokers, the Federal Reserve Board, the Internal Revenue Service, and the Department of Labor. These agencies ensure that mortgage brokers comply with the aforementioned federal laws, as well as small business and work-place regulations such as wage, hour and overtime requirements, the do-not-call registry, and can-spam regulations, along with the disclosure and reporting requirements associated with advertising, marketing and compensation for services.

b. Mortgage Broker Regulation in the States

The regulation of mortgage brokers begins at the federal level, but it certainly does not end there. Mortgage brokers are licensed and registered and must comply with pre-licensure and continuing education requirements and criminal background checks in every state pursuant to the Secure & Fair Enforcement for Mortgage Licensing Act of 2008 ("SAFE Act") – a law for which NAMB advocated more than six years before its enactment.

The SAFE Act is designed to enhance consumer protection and reduce fraud by encouraging states to establish minimum standards for the licensing and registration of state-licensed mortgage loan originators and for the Conference of State Bank Supervisors (CSBS) and the American Association of Residential Mortgage Regulators (AARMR) to establish and maintain a nationwide mortgage licensing system and registry for the residential mortgage. The SAFE Act requires all mortgage originators to adhere to such licensing and registration requirements, with the exception of loan officers at federally chartered institutions.

As small businessmen and women, mortgage brokers must also comply with numerous state anti-predatory lending and consumer protection laws, regulations and ordinances (*i.e.*, UDAP Regulations).

Again, this is not true for a great number of depository banks, mortgage bankers, mortgage lenders and their loan officer employees, which remain exempt from such requirements under federal agency preemption. Many states also subject mortgage brokers to oversight, audit and/or investigation by mortgage regulators, the state's attorney general, or another state agency, and in some instances all three.

To the extent that the CFPA will enhance uniformity in the application of the regulations and laws stated herein that provide for consumer protection, NAMB supports such an objective.

IV. Jurisdiction of the CFPA

The Administration Plan would vest the CFPA with the responsibility of implementing the Truth-in-Lending Act ("TILA"), Home Ownership and Equity Protection Act ("HOEPA"), Real Estate Settlement Procedures Act ("RESPA"), Equal Credit Opportunity Act ("ECOA"); and the Home Mortgage Disclosure Act ("HMDA"), among other statutes. The agency would be granted broad consolidated authority over the functions of rule-writing, supervising and examining regulated entities, and administratively enforcing violations of the statutes it is charged with enforcing.

The CFPA would also be granted authority over all persons covered by the statutes the agency implements, including banks and bank affiliates, non-bank entities, and institutions currently regulated exclusively by one of the federal prudential regulators.

The CFPA's mission would be to help ensure that (1) consumers are provided the information they need to make responsible financial decisions; (2) consumers are protected from abuse, unfairness, deception and discrimination; (3) the markets for consumer financial services operate fairly and efficiently; and (4) traditionally underserved consumers and communities have access to financial products and services.

One fact lost in debates over mortgage policy is the fact that mortgage products are created by very few entities and that products are repackaged and re-branded by many "product" distribution channels. We do appreciate the CFPA's approach of the application of uniform legal standards to all originators so that consumers are free to shop and compare mortgage products and pricing among different distribution channels without fear or confusion. Because each distribution channel is competing for consumers' mortgage loan business, consumers are best served when every mortgage originator is held to the same professional standards under the law. For many years, stronger market competitors have used state and federal mortgage disclosure and other laws to create a competitive advantage over weaker competitors. These actions have only confused consumer understanding of mortgage products.

However, we also believe that there should be some standards in place to prohibit the CFPA from imposing overly prescriptive measures to the detriment of consumers. Ultimately, the CFPA may be regulating in areas that have not been addressed by Congress and therefore, not subject to hearings, oversight or certain checks and balances as provided through the legislative process.

V. Board Makeup

According to the Administration's Plan, "The Agency shall seek to promote transparency, simplicity, fairness, accountability and access in the market for consumer financial products or services." NAMB agrees with such objectives, and before we delve into the particular areas addressing the general powers of the CFPA, we think it is imperative to address the consistency of the CFPA board members.

The Board is established as an "independent" agency within the Executive Branch of the federal government to regulate consumer financial products, services, and service providers. The CFPA would be governed by a board composed of 5 members, one of which will be the director responsible for heading up the merged Office of the Comptroller of Currency (OCC) and the Office of Thrift Supervision (OTS). The other 4 members of the board will be appointed by the President and confirmed by the Senate for staggered terms. One of the Board members will be designated as the chief executive of the CFPA. Unlike other federal agencies which are delegated rulemaking and enforcement authority, such as the Federal Trade Commission and the Securities and Exchange Commission, the CFPA does not impose any requirement that a particular number of board members be from a political party different than the party of the President who appoints them. This raises serious concerns about whether the CFPA can truly function as an independent agency, or whether it could be used as a means for a President to circumvent Congress and legislate without any meaningful checks and balances.

Additionally, because the President may remove any appointed Board member for inefficiency, neglect of duty, or malfeasance in office (which are very subjective terms and undefined in the legislation) the Board's independence may again be called into question. Such criteria for removal would not be concerning if there were bipartisan representation on the board.

In addition to requiring that no more than 3 Board members be of the same political party, we recommend that the Board have proper industry representation and be comprised of individuals who possess business acumen and an understanding of the market for consumer financial products and services.

VI. Fees

The CFPA grants broad authority to impose fees and assessments on "covered persons." NAMB is concerned that those regulated on the state level, such as mortgage brokers, may be forced to pay more to do business, which will place such entities at a competitive disadvantage and will ultimately increase costs for consumers.

Additionally, there is absolutely no limitation on the fees charged and the legislation does not correlate the fees with a covered person's business size or transaction engagement.

VII. Exemptions

The purpose of the agency is to promote transparency, simplicity, fairness, accountability, and access in the market for consumer financial products or services, and to ensure the markets for consumer financial products and services operate "fairly and efficiently" with "ample room for growth and innovation." However, the bill specifically allows for exemptions for any covered person, product or service that meets specified criteria, which small business professionals are not likely to meet. If the CFPA's mission is to truly create uniformity of all products and services and protect consumers regardless of where they shop, providing for exemptions is contrary to such a goal. There should be no exemptions or a tiered form of exemptions, *i.e.*, very large covered persons, those covered persons that provide de minimis services and products.

VIII. Directive to Review Existing Regulations

As was clearly stated in the Administration's policy paper, the financial regulatory reform effort is not about more regulation. It is about better regulation. The Administration Plan would require the CFPA to complete comprehensive regulatory studies of every new regulation that is enacted, in order to assess the effectiveness of such regulation in meeting its stated purposes and goals. Additionally, the CFPA would be directed to review existing regulations for similar purposes.

NAMB strongly supports empowering the CFPA to undertake a comprehensive review of new and existing regulations. Too often, in the wake of our current financial crisis, we have seen new rules promulgated that do not reflect measured, balanced solutions to the problems facing consumers and our markets. The Home Valuation Code of Conduct ("HVCC") provides one such example.

The HVCC is the result of a joint agreement reached in March 2008 between Fannie Mae, Freddie Mac (together, the "GSEs"), the Federal Housing Finance Agency ("FHFA"), and New York Attorney

General, Andrew Cuomo. The HVCC purports to enhance the independence and accuracy of the appraisal process. However, what the HVCC truly accomplishes is an increase in consumer costs, a decline in appraisal quality, the extension of closing deadlines, and the virtual extinction of local small business appraisers.

The HVCC is a substantive rule that affects consumers and regulates mortgage and appraisal professionals in all 50 states. Yet, the HVCC was promulgated by an agency – the FHFA – charged with ensuring safety and soundness and promoting a stable and liquid mortgage market, which clearly falls outside of the HVCC's purpose and objective. Moreover, the HVCC was drafted, revised, and implemented by the FHFA outside of the federal rule-making procedures required under the Administrative Procedures Act ("APA").

NAMB believes it is important to strengthen the integrity and independence of the home appraisal process, as appraisal independence is essential to protecting consumers from fraud and from unscrupulous actors. However, NAMB does not believe the FHFA acted in the best interests of consumers when promulgating the HVCC and NAMB does not believe the FHFA should be instituting measures that would more properly fall under the authority of an agency like the CFPA.

NAMB strongly supports H.R. 3044, the legislation introduced by Rep. Travis Childers and Rep. Gary Miller to impose an 18-month moratorium on the HVCC. NAMB commends Representatives Childers and Miller for their leadership on this issue and we thank the members of this Committee who have agreed to co-sponsor this important piece of legislation. We urge this Committee to direct the FHFA to withdraw the HVCC immediately, and to empower the CFPA with the authority to undertake rule-writing that more appropriately regulates appraisal activities, ensures appraisal independence, and protects consumers.

Additionally, NAMB believes that H.R. 3126 should be amended to specifically preempt any state statute from having any force or effect where the CFPA or a similar federal agency is vested with authority under any federal statute to provide similar protection to consumers that the state statute provides. The Consumer Product Safety Act[2] preempts any state from establishing or continuing any safety standard designed to deal with the same risk of injury as a federal standard, unless it is identical to the federal standard. H.R. 3126 should similarly restrict the potential establishment of 50 different consumer protection standards in addition to those promulgated by the CFPA.

The impetus behind the ill-conceived HVCC was the use of an extremely broad and controversial state statute to investigate possible financial fraud at a large lending institution in the state of New York. As this investigation unfolded, the New York Attorney General utilized his virtually boundless authority under the statute to expand his investigation into certain activities at the GSEs. Although the HVCC is a substantive rule, ultimately promulgated by a federal agency – the FHFA – it stems directly from the New York Attorney General's use of the highly controversial Martin Act[3], which vests unprecedented investigatory and prosecutorial powers with a single State Attorney General.

Specifically, New York's Martin Act grants the Attorney General the power to subpoena virtually any document from any individual or entity doing business in the state of New York. The Martin Act also permits the New York Attorney General to commence an investigation whenever he believes it is in the public interest that an investigation be made, or whenever it appears any person has engaged in fraudulent practices. Moreover, once an investigation has been initiated under this Act, the New York Attorney General is relieved of any obligation to demonstrate probable cause or to disclose the details of the

[2] 5 U.S.C. 2051, et. seq.

[3] IN.Y. GEN. BUS. LAW, Art. 23-A, § 352 et seq.

investigation. Additionally, anyone brought in for questioning during a Martin Act investigation does not have a right to counsel or a right against self-incrimination, and the Attorney General may prevail in a case without proving there was any intent to defraud, that anyone was actually defrauded, or even that a transaction actually took place.

The Martin Act in New York is the paramount example of state regulation already in existence that runs afoul of the purposes and objectives behind establishing the CFPA. NAMB strongly believes H.R. 3126 should preempt the Martin Act, as well as any other current or subsequently enacted statutes having the same force and effect in other states.

IX. Creation of an Outside Advisory Panel

NAMB supports the proposal in the Administration's Plan to create an outside advisory panel, akin to the Federal Reserve Board's Consumer Advisory Council, to encourage accountability on the part of the CFPA and allow for the useful sharing of information regarding emerging industry practices. NAMB believes such a panel must be comprised of enough members to fairly represent all segments of the industry, as well as consumers, and NAMB would welcome an opportunity to participate on such a panel. However, clarification is required as to the makeup of the Consumer Advisory Board, specifically with regard to how large it will be and what "a full time employee of the United States" actually means.

X. Administration of the S.A.F.E. Act

NAMB believes that the Secure & Fair Enforcement for Mortgage Licensing Act of 2008 ("SAFE Act") should be amended to ensure that the CFPA possesses complete and exclusive authority to implement the entire Act, including oversight of the operations of the registry created by the Act. Transferring total administrative authority over the SAFE Act to the CFPA will eliminate any potential gaps in coverage, where lesser standards and/or the exemption or insulation of a certain class or group of individuals who originate loans may persist. This will also eliminate the seemingly conflicting language in H.R. 3126 that encourages states to apply standards to non-depository and credit union covered persons, including background checks, education requirements, registration, etc.

NAMB strongly supports making the CFPA the sole federal agency responsible for administering the SAFE Act. Authority to administer the SAFE Act is currently divided among several federal agencies, and NAMB believes consumers would benefit greatly from having unified authority vested in a single federal regulator responsible for overseeing the implementation and administration of the SAFE Act.

To help illustrate this point, one need not look further than the recently published "proposed rules" to implement the SAFE Act, issued jointly by the federal banking agencies – the Office of the Comptroller of the Currency; Federal Reserve Board; Federal Deposit Insurance Corporation; Office of Thrift Supervision; and National Credit Union Administration. The failure of these agencies to properly emphasize and implement important consumer protection measures set forth in the SAFE Act highlights one of the fatal flaws in a fragmented approach to regulatory oversight of consumer protection measures, like the SAFE Act.

In these proposed rules, the five federal banking agencies seek to implement only the bare minimum requirements for consumer protection set forth in the SAFE Act with respect to agency-regulated institutions. Moreover, the agencies seek to delay any implementation of the SAFE Act's consumer protection requirements for agency-regulated institutions for at least 180 days from the time the agencies announce that the national registry is actively accepting initial registrations. Lastly, these agencies have proposed exemptions to SAFE Act requirements for some of their employees.

NAMB believes responsibility for implementing the SAFE Act should be vested exclusively with a single federal regulator focused on consumer protection, like the CFPA. Additionally, NAMB believes in keeping with the broad authority granted to the CFPA under the Administration's Plan, that the CFPA should undertake comprehensive rulemaking to extend and implement the most critical consumer protections included in the SAFE Act – namely, the education and testing requirements – so that all loan originators are held to the same high standards, including those who are employees of federally-regulated institutions.

While states are now required under the SAFE Act to increase standards for state-licensed mortgage originators, employees of federally-regulated institutions continue to escape requirements that they meet important benchmarks for training, continuing education, and proficiency testing. Today most consumers are unable to distinguish one mortgage originator from another (i.e., a state-licensed mortgage originator vs. a loan officer employee of a federally-regulated institution), so why should some of our most important consumer protection regulations make such a distinction?

NAMB strongly believes that even more can and should be done to increase professional standards for all mortgage originators. Great strides were made with the passage of the SAFE Act in 2008. However, even in passing the SAFE Act, there remain cracks in our consumer protection regulatory framework where loan originators employed by certain entities or institutions must meet more rigorous standards than loan originators at other institutions.

Today NAMB is advocating for an extension of the consumer protection requirements set forth in the SAFE Act so that all mortgage originators, including employees of federally regulated banks and other institutions are required to satisfy the same education and testing requirements.

XI. Consumer Education & Financial Literacy

NAMB supports the CFPA playing a leading role in efforts to educate consumers about financial matters, improve consumers' ability to manage their own financial affairs, and make proper judgments about the subjective appropriateness of certain financial products.

NAMB believes that consumers are, and should remain, the ultimate decision-maker when it comes to the product, pricing, and service offered in connection with a financial transaction. Therefore, it is imperative that consumers possess the necessary financial knowledge to carefully evaluate the risks and rewards presented by different financial products and be able to determine the appropriateness of such products for their particular needs.

In the context of mortgage transactions, regardless of how knowledgeable a loan originator is or becomes, an educated consumer is always in a better position to make an informed decision when selecting a mortgage product to match his or her financial needs and goals.

NAMB has always been a strong advocate for consumer financial literacy efforts. It is our firm belief that an educated borrower is significantly less likely to fall victim to any abusive lending practices, and that is why we support the Administration's proposal to make consumer education and financial literacy a key component of the larger financial regulatory reform effort. We urge Congress to require the CFPA to utilize modern testing of forms and consumer choice science to formulate modern mortgage disclosure forms. We believe this is a cornerstone of financial literacy. Disclosures that confuse consumers lead to incorrect choices and open the door for unscrupulous actors to take advantage of the consumer.

XII. Specific Consumer Protection Reforms

The Administration's Plan calls for a series of legislative, regulatory and administrative actions to reform consumer protections, based upon the principles of transparency, simplicity, fairness, accountability and access.

Although NAMB welcomes transparency across the entire mortgage market, NAMB would caution the CFPA, or any such regulator, against potentially causing unintended harm to consumers in the process of revising disclosures and attempting to simplify what has become a very complex mortgage process. NAMB strongly believes that any effort to improve simplicity and fairness in mortgage transactions must respect the complexity of today's market and emphasize transparency at each stage in the lifecycle of a loan – from origination through sale or securitization.

No single aspect of a mortgage transaction should be examined in a vacuum. While transparency is critical at origination, if it exists there alone it is meaningless and confusing to consumers. There must also be transparency in the processes extending beyond origination but affecting the products and prices available to consumers.

To the extent the Administration's Plan and this Committee endeavor to improve transparency, simplicity, and fairness at origination and throughout the entire life cycle of a mortgage, NAMB is very supportive.

a. Transparency – Balanced, Clear, Concise & Consumer-Tested Disclosures

The Administration's Plan calls for mandatory disclosure forms that are simple, clear, concise and consumer-tested. NAMB generally supports greater transparency in consumer financial transactions, and is very supportive of efforts to simplify, clarify and effectively consumer-test all mandatory disclosure forms. Many current disclosures have failed to keep pace with market innovations and increasing transaction complexity. At the same time, recent efforts to revise antiquated disclosure forms, such as the Goof Faith Estimate, have failed to demonstrate their effectiveness through consumer testing.

NAMB is very supportive of the concept in H.R. 3126 to require a model disclosures that combine the disclosures required under TILA and RESPA into a single, integrated disclosure for mortgage loan transactions. Consumers will greatly benefit from a single, integrated and uniform federal mortgage disclosure form which clearly and simply discloses critical loan terms and costs.

Additionally, NAMB strongly encourages this Committee to consider imposing a moratorium on the implementation of any new regulations or disclosure forms issued by HUD and FED for at least 1 year after the designated transfer date. This will help avoid consumer confusion and minimize the increased costs and unnecessary administrative burden borne by industry participants if multiple significant changes are made to mandatory disclosure forms over a short period of time.

The Administration's Plan and H.R. 3126 seek to provide consumers with disclosures that help them to understand the consequences of their financial decisions. NAMB strongly supports this goal and has long-advocated for clear, consistent, and uniform communication with consumers from the shopping stage through closing, and afterwards throughout the life of the loan (i.e., through monthly statements).

Regardless of the form that a consumer disclosure takes, there are certain essential elements that NAMB believes must be included in order for the form to effectively aid consumers in making appropriate financial decisions. First, an effective consumer disclosure must be even-handed. The disclosure must be uniform and equally applicable to all individuals and entities engaged in the activity being regulated through disclosure. Second, an effective consumer disclosure must be informative. Consumers must be provided clear statements of fact concerning the roles of the parties to the transaction, as well as a clear breakdown of estimated costs or other critical information associated with the transaction. Third, an effective disclosure must be proven effective. Disclosures must be consumer-tested in real-life situations and objectively evaluated to determine whether they are in fact communicating the proper information to consumers and are doing so in a clear and concise manner.

Moreover, NAMB believes all agencies and any future ones be required to consumer-test all current disclosure forms, as well as any new disclosure forms aimed at helping consumers understand financial products and services better. This testing should focus on the disclosure's effectiveness in communicating critical information to the consumer, as well as any potential negative affects that the disclosure could have on competition between market participants.

Finally, as the Administration's policy paper correctly points out, regulators are typically limited to testing disclosures in a "laboratory" environment, which can skew results and lead to the widespread implementation of an ineffective disclosure form. Field-testing can, and often does, produce more accurate results and more useful feedback. NAMB supports the provisions of the Administration's Plan that call for the establishment of standards and procedures for effectively conducting field tests of consumer disclosures before they are implemented and required across the board.

b. Simplicity – "Plain Vanilla" Mortgage Products

The legislation mandates that rules requiring a covered person to offer a "standard consumer product or service" at the same time or before it offers an "alternative consumer product or service." It also authorizes the CFPA to adopt rules regarding the offer of standard and alternative consumer products and services including warnings about the heightened risks of alternative consumer products and services and rules requiring that consumers be provided a "meaningful" opportunity to decline to obtain the standard consumer financial product or service.

The term the Administration's Plan uses to describe these less risky, simpler products is "plain vanilla." In the context of mortgages, "plain vanilla" products would have either fixed or adjustable rates, predictable payments, mandatory escrows for taxes and insurance, and no prepayment penalties attached. The idea behind these "plain vanilla" products is that they could be compared and differentiated by a single, simple characteristic, i.e., the interest rate.

NAMB is supportive of efforts to simplify the process of obtaining a mortgage. However NAMB is concerned that efforts to simplify and standardize mortgage products could have serious negative consequences for consumers looking to find the most appropriate and cost effective loan for their situation. Specifically, NAMB is worried about the unnecessary additional costs of developing new products, questionnaires, and opt-in disclosures that would likely be passed-on to consumers if institutions' product offerings are overregulated. Additionally, NAMB is concerned that consumers may fall into the trap of merely opting for the "plain vanilla" mortgage product, regardless of its appropriateness for their particular situation, simply because it appears to be preferred and may falsely be interpreted as a "government approved" product. NAMB is not supportive of the "plain vanilla" concept.

c. Fairness – Duties Owed to Consumers by Originators & Entities

H.R. 3126 imposes duties on covered persons and their agents and employees to ensure fair dealing with consumers in financial transactions. Such rules may establish duties regarding compensation practices, but specifically prohibit the CFPA from capping the amount of compensation paid to any person.

NAMB has some concerns about this broad power without any rules of construction to ensure that there is no disparate treatment among industry participants. NAMB is concerned about the CFPA's ability to remove consumer financing options and we believe that the CFPA should be provided with some specific rules of construction in interpreting this section.

NAMB does, however, appreciate the importance of ensuring that loan originators are not incentivized to steer consumers into particular loan products purely for personal gain, and NAMB is very supportive of efforts to eliminate any such incentives from the marketplace. Therefore, NAMB commends the Administration's Plan for recognizing and proposing affirmative steps be taken to require banks and lenders to disclose to consumers the payments made to their employees called "overages," as well as their "service release premiums."

NAMB supports those provisions in the Administration's Plan that call for all originators, including banks and non-depository lenders, to disclose all direct and indirect income generated in a mortgage transaction, as mortgage brokers have done since 1992. In fact, NAMB advocates for utilizing the mortgage broker model of complete financial disclosure to effectively reveal the heretofore hidden bank payments to loan officers and service release premiums.

Although not in the bill, included in the Administration's Plan is the CFPA's authority to require loan originator compensation to be tied to loan performance and paid-out over the life of a loan, as opposed to in one lump sum upon origination.

NAMB sees a number of specific practical flaws in the Administration's Plan to propose regulations linking loan originator compensation with the longer-term performance of a loan. Loan originators earn their compensation when they successfully match a loan product with a customer's individual needs and desires for home financing and are involved in that transaction through to closing. Additionally, lenders create mortgage products, determine the type of risk they are looking for and price that risk accordingly.

i. Standards of Care

The Administration's Plan also proposes granting the CFPA the authority to impose certain duties of care on the providers of financial products and services. In prescribing such regulations, the CFPA shall consider whether (1) the covered person is acting in the interest of the consumer with respect to any aspect of the transaction; (2) the covered person provides the consumer with advice; (3) the consumer's reliance on any advice from the covered person would be reasonable and justifiable under the circumstances; (4) the benefit to the consumers of imposing a duty would outweigh the costs; and (5) any other factors the CFPA deems appropriate.

Since 2002, NAMB has advocated for more stringent standards for all loan originators to protect consumers and curb abusive lending practices in the mortgage industry. However, NAMB cautions the CFPA, or any regulator attempting to implement a standard of care for mortgage originators, that there is a likelihood of unintended negative consequences for consumers if such a standard is overly restrictive or under-inclusive of essential market participants.

NAMB believes that a standard of care should apply whenever a person is acting as a loan originator under the definition in the SAFE Act, and should be broad and flexible enough to operate as a ceiling, not a floor, in establishing a loan originator's responsibilities when working with consumers. Also, because the acts of originating, funding, selling, servicing, and securitizing mortgage loans may all be conducted separately and independently, or may be engaged in collectively under one corporate structure or through affiliated business arrangements, it is important for consumer protections to relate to the function, as opposed to the structure of entities. In the end, consumers deserve the same level of protection no matter where they choose to obtain a mortgage loan.

Specifically, NAMB believes that any person required to be licensed or registered as a loan originator under the SAFE Act should have a federal statutory duty to exercise good faith and fair dealing in all communications and transactions with consumers. All loan originators should be held to the same standard of conduct toward consumers so that all consumers are shielded from the potentially grave consequences that can occur when transacting business with under-qualified individuals, regardless of whether they are working with a federally-chartered bank, state-chartered lender, credit union, or mortgage broker. In addition, if the CFPA requires disclosure or duties on any particular mortgage provider, the CFPA should require disclosures to be symmetrical. Meaning, those with no duty to the consumer must disclose that fact to their customer.

ii. Consistent Regulation of Similar Products, Services & Providers

NAMB strongly supports the Administration's emphasis on fairness and the preservation of effective competition on our financial markets throughout its policy paper. We agree entirely with the Administration that similar disclosures for similar products, services, and providers enables consumers to make more informed choices based upon a full appreciation of the nature and risks involved in a given transaction.

We do not deny that differences exist between depository and non-depository institutions, both in terms of their business models and how they are currently regulated. However, when it comes to the contact with consumers in the context of mortgage loan origination, these entities are virtually indistinguishable, particularly in the eyes of consumers, and therefore should be regulated by a single federal agency and held to the same standards as their competitors.

XIII. Conclusion

NAMB greatly appreciates the opportunity to discuss "The Impact of Financial Regulatory Restructuring on Small Businesses and Community Lenders" with this Committee. Although we generally support many of the consumer protection measures outlined in the Administration's Plan, we do have concerns over certain specific elements of the proposal as they may have a disproportionate and profoundly negative impact on all small businesses, and particularly mortgage brokers.

Mortgage brokers and other small business originators have already suffered a tremendous loss of market share in the wake of the financial crisis and subsequent government-backing of larger institutions. In fact, during the first half of 2009, 52% of all mortgage originations were handled by three federal depositories.[4]

We are deeply concerned that without adequate accounting for the interests of small businesses in any proposed financial regulatory restructuring, competition will further erode, small businesses will become extinct, and consumers will suffer the consequences of a mortgage and financial market controlled by a corporate oligarchy.

Thank you again for inviting NAMB to appear before this Committee and discuss these very important issues affecting both small businesses and the consumers they serve.

[4] Peter Eavis, *Uncle Sam Bets the House on Mortgages*, WALL ST. J., September 18, 2009 (see attached).

Testimony of J. Douglas Robinson
Chairman and Chief Executive Officer
Utica National Insurance Group
On Behalf of the Property Casualty Insurers Association of America (PCI)

The Impact of Financial Regulatory Restructuring on Small Businesses and Community Lenders
Committee on Small Business
United States House of Representatives
Wednesday, September 23, 2009

Chairwoman Velázquez, Ranking Member Graves, and members of the Committee, thank you for the opportunity to testify today on the impact of financial services regulatory reform proposals on small businesses. My name is J. Douglas Robinson and I am the Chairman and Chief Executive Officer of the Utica National Insurance Group, a group lead by two mutual insurers headquartered near Utica, NY. Utica National provides coverages primarily for individual and commercial risks, with an emphasis on specialized markets including public and private schools, religious institutions, small contractors and printers. My company markets its products through approximately 1,200 independent agents and brokers. Our 2008 direct written premium was more than $632 million. I am testifying today on behalf of the Property Casualty Insurers Association of America (PCI), which is the leading property-casualty trade association in the United States, representing more than 1,000 insurers, the broadest cross-section of insurers of any national trade association.

PCI commends President Obama and Congress for working to ensure that the financial crisis we experienced last fall is never repeated. Achieving that goal will require a comprehensive assessment of the root causes of the crisis and a commitment to enacting legislation that addresses those causes without imposing substantial new regulatory burdens on entities that did not cause the crisis and are not systemically risky. Simply put, we need to fix what's broken, not what is working. The Wall Street meltdown was caused primarily by large, highly leveraged businesses. To fix these behemoth, "too interconnected to fail" firms, policymakers need to avoid costly one-size-fits-all regulations that would undermine firms that provide the small business community access to capital and protection from risk. My company insures small businesses like bakeries, child care centers, auto service centers and funeral homes. These Main Street businesses, as well, should not bear the burden of an economic crisis they did not cause.

There is widespread recognition that home, auto and commercial insurers did not cause the financial crisis, are not systemically risky, and are subject to strong and effective solvency and consumer protection regulation at the state level. We are predominately a Main Street industry, not Wall Street, with significantly less concentration and more small business competition than other financial sectors. Property-casualty insurers have not asked for government hand-outs, and our industry is stable, healthy and continuing to provide critical services to local economies and their communities.

However, small insurers are very concerned about being subject to Administration proposals intended to address risky Wall Street banks and securities firms that broadly apply to the entire financial industry. These proposals will impose costly and duplicative regulation and restructuring on some insurers who are serving local communities, are not systemically risky and are already well and extensively regulated. Small insurers, who have fewer resources to cope with new layers of regulation, would suffer the most from the impact of additional cost burdens. Small business policyholders, who make up the majority of our commercial consumers and are already struggling through the current economic crisis, could feel the cost impact mostly keenly with increased rates (as some companies are compelled to pass on increased costs to consumers to keep their own financial measures in line) and reduced competition.

There are numerous aspects of the Administration's proposals that threaten to have a substantial negative impact on small insurers and their customers if not appropriately limited. My testimony highlights just of a few of these concerns:

Consumer Financial Protection Agency (CFPA). The Administration has proposed creating a new Consumer Financial Protection Agency (CFPA). While the focus of the Agency appears to be regulating the market conduct of credit and mortgage related activities, the exclusion provided for insurance activities is incomplete.

Property-casualty insurance is perhaps the most heavily regulated financial services industry in the United States. Consumers receive extensive and effective oversight over every phase of their contact with an insurer or its representatives, including restrictions on who can sell insurance (*e.g.*, solvent insurers, subject to financial examination, staff of good character/credentials), how insurers deal with their customers (*e.g.*, types and limits of coverage sold, cancellation and non-renewal restrictions) and safeguards after the sale (*e.g.,* claims processes, unfair trade practices proscriptions, state guaranty funds to protect policyholders of insolvent insurers). While the Administration has recognized these heavy state restrictions by generally excluding insurance from the Agency's scope, this exclusion needs to be strengthened to avoid creating new layers of bureaucracy and regulation that will create enormous and disproportionate burdens for small insurers and their small business consumers:

1. The exclusion for insurance is only made part of the definition of financial products, as opposed to tracking the more comprehensive exclusion provided for entities regulated by the Securities and Exchange

Commission (SEC) and the Commodities Futures Trading Commission (CFTC). This limited definition unintentionally opens several loopholes allowing the CFPA to reach into the insurance industry despite the clear opposite intent of the legislation, for example by deeming insurance to be a financially related activity. Small insurers would have the least ability to absorb the costs of complying with a duplicative regulator and restrictions.

2. Small insurers often offer their customers, particularly smaller customers, flexible payment plans allowing insurance payments to be made in monthly installments for a small fee. Without an express exclusion, the CFPA might attempt to label this service inappropriately as an extension of credit, seeking to regulate it as an activity outside of the insurance exception. Such overreach is not without precedent -- the Federal Trade Commission (FTC) has recently sought to include such insurance payment plans inappropriately within the definition of "credit" in its identity theft "red flag" rules, resulting in expensive litigation and regulatory uncertainty. Insurance premium payment transactions are already subject to extensive state insurance regulation and oversight and should be exempt from the CFPA's scope unless the transaction involves a separate financing document and an interest charge.
3. The insurance exception in the current bill does not include credit insurance, mortgage insurance, and title insurance, which are singled out for duplicative federal regulation. There is no need for an additional layer of federal CFPA bureaucracy to impose duplicative regulation on them. None of these products has been suggested as a contributing cause to the current financial crisis, nor has any rationale been advanced for their duplicative regulation other than their relatedness to federally overseen credit and mortgage lending that has been questioned. Subjecting regulated state products to federal oversight with a questionable past is potentially breaking something that doesn't need to be fixed. In fact, ill-advised restrictions on the credit insurance market could limit its availability at a time when the benefits it provides to small businesses are most sorely needed. Credit, mortgage, and title insurance are no different from other property-casualty activities and should continue to be fully and well regulated at the state level, without duplicative and costly federal CFPA regulation.

Non-Bank Depository Institutions (NBDIs). The Administration has proposed forcing all holding companies with depository institutions to convert to bank holding companies (BHCs) and to be subject to the more stringent BHC financial regulation. This proposal misidentifies the problem, is unnecessary, and would create massive unintended consequences and cost burdens for many small businesses. There has unfortunately been a mixed history of oversight by the Office of Thrift Supervision (OTS), with several cycles of failures of large thrifts occurring in recent decades. However, the Administration's proposal is not directed at fixing and strengthening OTS regulation. Instead, the proposal would completely eliminate all non-bank depository institutions (NBDIs), including thrifts, industrial loan companies, credit-card banks, and other non-bank banks, and force their holding companies to become bank holding companies subject to extremely restrictive Federal Reserve Board oversight and regulation. For example, small insurers with thrift affiliates that also own small commercial operations, such as dairy co-ops and seed farming would be forced to completely divest such operations and undergo a very expensive holding company restructuring. This will injure a wide spectrum of financial and commercial small business consumers and again demonstrates how Main Street can be harmed when the focus is just on Wall Street.

Most NBDIs, particularly insurance-affiliated NBDIs, are relatively small. Insurance affiliated NBDIs did not cause the crisis, are not systemically risky, and are usually limited in their operations, either by size, a focus on servicing the holding company, or limited to non-mortgage/consumer lending activities. Imposing a forced-conversion on existing NBDIs would have little societal value, but would impose substantial costs on insurers, particularly smaller insurers that cannot afford required restructuring costs. Abruptly imposing BHC regulation on holding companies with NBDIs would create unintended consequences that would hurt both consumers and the economy. With economic recovery so closely tied to the loosening of credit markets, now is not the time to impose new and unnecessary regulatory burdens on credit providers and risk further limiting the availability of credit, including credit sorely needed by small businesses trying to keep their head above water in these difficult times.

Specifically, the NBDI proposal would:

- Force holding companies to divest their NBDIs or key non-banking subsidiaries – a costly endeavor that could reduce the availability of consumer financing and reduce capital availability
- Require inappropriate stress testing and costly compliance regulations on non-systemically risky NBDIs, thereby increasing consumer costs
- Require the extinguishing of existing charter limitations on NBDI-associated activities that support the holding company
- Reduce the diversity of activities in which a company can engage by forcing divestiture of non-financial activities, when those activities are appropriate, well-managed and beneficial to the community at large
- Dismantle existing regulatory and/or corporate structures that "wall off" the activities and liabilities of the NBDI management from the holding company
- Require inappropriate accounting changes
- Inappropriately reduce national preemption standards
- Jeopardize the NBDI charter
- Require companies to conform to the unnecessary new BCH compliance requirements more quickly than they are able to do so

Because of the harmful effects listed above, we believe that a provision forcing NBDIs to convert to a BHC structure should not be included in any financial services regulatory reform legislation that Congress passes. If Congress wishes to address OTS oversight or eliminate banking regulatory arbitrage, these goals can be accomplished without eliminating existing non-systemically risky NBDI charters, and without imposing the full range of "fed-heavy" BHC regulation.

Office of National Insurance (ONI). The Administration has proposed creating an Office of National Insurance within the Treasury Department, despite over a century of successful state insurance oversight. The ONI would have considerable power to impose substantial new reporting requirements on insurers, which could be quite burdensome and costly, especially to small insurers. The ONI's subpoena power is unusually broad, far exceeding other Treasury agencies and very exceptional for a non-regulator. The ONI could also preempt state laws protecting small insurers, such as reinsurance collateral arrangements, pursuant to international agreements it could enter into. This preemption power lacks the due process and limits on negotiating authority of earlier, more broadly supported bipartisan proposals sponsored by Representative Kanjorski and others.

While the Administration has wisely directed the ONI to consider obtaining needed information from existing state regulators and has suggested creating a "small insurer" exception from the ONI's subpoena powers, the draft legislation lets the ONI determine the scope of this exception without limit. PCI has suggested that policymakers consider explicitly defining the term "small insurer" (for example using existing insurance corporate governance standards). PCI has also recommended including appropriate due process protections (such as those from similar existing Congressional proposals), limiting the scope of the ONI to avoid otherwise inevitable mission creep, and clarifying the limits of the ONI's binding negotiating authority.

Systemic Risk. PCI supports the Administration's efforts to improve systemic risk oversight and has provided extensive factual data demonstrating that homeowners, auto, and commercial insurance is not systemically risky. PCI has also proposed extensive metrics and analysis for measuring and overseeing systemic risk. Most small businesses are not, and should not be considered, "Too Big to Fail" or "Too Interconnected to Fail" and thus subject to the Administration's proposed systemic risk regulation. However, the actions of the current and previous Administration have actually led to the significant expansion of large, leveraged, concentrated businesses, and created the moral hazard of implicit government backing of large firms – to the great competitive disadvantage of small businesses that lack the same backing or access to federal hand-outs and arranged mergers. PCI appreciates that many Administration and Congressional leaders recognize this issue and urges them to modify the legislation to limit systemic risk regulations to only highly leveraged and interconnected entities to ensure their orderly failure, while limiting future government exposure and limiting the picking of large winners or losers.

Derivatives Regulation. The Administration has proposed new legislation to improve the regulation of derivatives products. While PCI supports the Administration's efforts to increase oversight of systemically risky activities, the proposed definition of derivatives is too broad. Derivatives are defined to include any transaction relating to a change in value in an asset or the occurrence of an event relating to the asset, which would inadvertently classify most state regulated property-casualty insurance contracts as derivatives. PCI has suggested a technical fix to exclude the business of insurance from each of the derivatives definitions, and is hopeful that it will be adopted.

Resolution Authority. The proposal to resolve failing systemically risky companies would enable a banking regulator to take control of all aspects of the failing holding company and ultimately charge the losses back to the entire financial industry. This could result in a bank regulator denuding the assets of an insurance affiliate of a risky holding company, whose losses would then be charged back to all insurers through the applicable state insurance guarantee funds, which may be in different states than the failing holding company. The same insurers would then have to pay a second time to the systemic risk regulator for its net losses. This double payment is unfair, not only because insurers are not generally systemically risky, but also because small insurers should not be required to absorb such unpredictable losses for which they were not responsible in the first place. Bank regulators should not be able to reach into insurance assets, other than through controlling the sale of affiliates. Insurers, especially small insurers, should not have to pay multiple times to backstop systemically risky companies which would ultimately negatively impact consumers.

McCarran-Ferguson Act. While not a part of the Administration's regulatory reform proposal, several members of Congress have proposed a partial repeal of the insurance antitrust safe harbor exemption under the McCarran-Ferguson Act. These proposals are usually based on a misguided notion that the Act's safe harbors are anticompetitive. The McCarran-Ferguson Act exemption allows the collection of critical insurance data, facilitates the development and operation of assigned risk plans and participation and oversight of state guarantee funds, permits state control over liquidations of insurers, allows greater standardization of insurance forms, and promotes competition in the marketplace. Creating more uniform development of policy forms is extremely beneficial for consumers who can then better compare competing insurance offers, and allows small insurers to compete on the same terms as large companies. Nationwide collection and pooling of insurance data is particularly necessary for small insurers who would not otherwise have sufficient information to determine expected claims losses and underwrite safely accordingly. Large insurers often have sufficient data internally in their primary lines of business to use as statistically significant indicators of loss costs. Small insurers have no way to price their products accurately without the availability of reliable industry-wide loss costs, and would otherwise suffer significant costs and market access barriers limiting their ability to effectively compete. Over time, a repeal of McCarran-Ferguson would threaten the small company franchise, prevent new entrants into the insurance industry, and have a chilling effect on the ability of existing insurers of all sizes to expand into new markets or new product lines. We strongly encourage the Congress and President Barack Obama to resist any calls for repeal of the pro-competitive insurer antitrust safe harbors in the McCarran-Ferguson Act, which could seriously harm both small insurers and their small business customers.

Impact on Small Business Consumers of Insurance

All of the concerns we have noted above have the potential to impose substantial (and in some cases, massive), costly new regulatory compliance burdens on insurers. Regulatory costs almost always hit small businesses harder because they lack the scale of their larger competitors. They can least afford to establish and staff large compliance departments to analyze and implement the mountains of new regulations, paperwork, examinations. Small insurers are also least able to afford implementing sudden forced changes in the way they do business, many of which are put forward as "one-size-fits-all" regulations which are entirely inappropriate when applied to Main Street institutions. Most small insurers serve small or regional markets to meet their unique needs, such as addressing floods in Missouri, earthquakes in California, or tornadoes in Kansas, and have many small businesses among their policyholders. Because of their small, regional nature, these insurers tend to know and be an integral part of their communities and the small businesses that operate in them. For this reason, many small businesses choose to do business with small local or regional insurers who are able to provide coverages tailored to their needs at a reasonable cost. One-size-fits-all federal regulation risks furthering consolidation favoring a few large Wall Street firms with national resource and access, while disfavoring small businesses that face more difficult compliance challenges.

In Conclusion

Overall, the property-casualty industry is very healthy and competitive, and the current system of regulating the industry at the state level is working well. In the past five years, home insurance companies have weathered hurricanes Katrina, Rita and Ike in addition to handling their regular claims during the economic crisis without having to ask for a government bailout. Home, auto and commercial insurers have been stable throughout the financial crisis and thus do not need additional regulation. Adding unproven federal regulations to existing effective state regulations will only duplicate efforts, make the system less efficient, and ultimately increase costs, particularly for small insurers and their small business consumers that can least afford the regulatory transitions. Property-casualty insurers are not systemically risky and did not cause the current crisis, and Congress should avoid inadvertently sweeping the industry into its regulatory reform agenda. Should the Congress fail to address the issues we have identified, the consequences on consumers and the economy could be quite harsh, imposing an especial burden on small insurers and small businesses.

We thank the Committee for the opportunity to highlight our concerns about the impact of financial services reform on small insurers and their customers and we would be pleased to provide any additional information or assistance the Committee may require.

Testimony of

Austin L. Roberts, III

On Behalf of the

AMERICAN **BANKERS** ASSOCIATION

Before the

Committee on Small Business

United States House of Representatives

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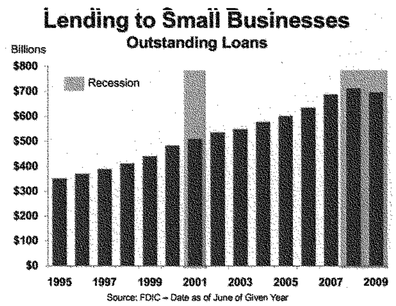
September 23, 2009

Chairwoman Velázquez, Ranking Member Graves and members of the Committee, my name is Austin Roberts, III. I am Vice Chairmen, President and CEO of Bank of Lancaster, headquartered in Kilmarnock, VA. My bank has $328 million in assets and we have served the northern neck of Virginia since we were founded in 1930. Small entrepreneurial businesses are, by far, the primary sector that meets the needs of the large retiree population in our trading area. The success of these businesses is very important to our communities and our bank. I am pleased to be here today representing the American Bankers Association (ABA), where I have served on the Board of Directors. ABA brings together banks of all sizes and charters into one association. ABA works to enhance the competitiveness of the nation's banking industry and strengthen America's economy and communities. Its members – the majority of which are banks with less than $125 million in assets – represent over 95 percent of the industry's $13.3 trillion in assets and employ over 2 million men and women.

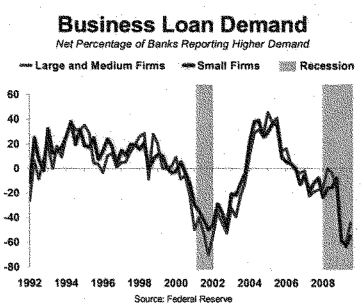
We are pleased to share the banking industry's perspective on the impact of financial restructuring and the current regulatory environment is having on lending to small businesses. Small businesses – including banks – are certainly suffering from the severe economic recession. While some might think the banking industry is composed of only large global banks, the vast majority of banks in our country are community banks – small businesses in their own right. In fact, over 3,500 banks (41 percent) have fewer than 30 employees.

This is not the first recession faced by banks. In fact, most banks have been in their communities for decades and intend to be there for many decades to come. The Bank of Lancaster has survived many economic ups and downs for almost 80 years. We are not alone, however. In fact, there are 2,556 banks – 31 percent of the banking industry – that have been in business for more than a century; 62 percent (5,090) of banks have been in existence for more than half a century. These numbers tell a dramatic story about the staying power of banks and their commitment to the communities they serve. My bank's focus, and those of my fellow bankers throughout the country, is on developing and maintaining long-term relationships with customers, many of which are small businesses located right down the street from our offices. We cannot be successful without such a long-term philosophy and without treating our customers fairly.

In this severe economic environment, it is only natural for businesses and individuals to be more cautious. Businesses are reevaluating their credit needs and, as a result, loan demand is also declining. Banks, too, are being prudent in underwriting, and our regulators demand it. With the economic downturn, credit quality has suffered and losses have increased for banks. Fortunately, community banks like mine entered this recession with strong capital levels. As this committee is aware, however, it is extremely difficult to raise new capital in this financial climate. The difficult recession, falling loan demand, and loan losses have meant that loan volumes for small business has declined somewhat this year (see chart on right). Let me be very clear here: even in a weak economy there are very strong borrowers. Every bank in this country is working hard to assure that our customers – particularly the small businesses that are our neighbors and the life blood of our communities – get the credit that deserve.



Hearings like this one, Madam Chairwoman, are extremely important. In order to assess the impact of new regulations and even proposals for a new regulatory body, it is critical for policy makers to understand the regulatory pressures that we face in today's environment. This is a difficult and critical time for banks, particularly small community banks. They find themselves besieged by deteriorating economies in many parts of the country; by overly restrictive rules and examinations that are making it hard to work through the problems; by government stimulus programs that have focused primarily on the largest and healthiest banks; and now by the government's proposed changes to the regulatory landscape that would only add to community banks' burdens.



We believe there are actions the government can take to assist viable community banks to weather the current downturn. The success of many local economies – and, by extension, the success of the broader national economy – depends in large part on the success of these banks. Comparatively small steps taken by the government now can make a huge difference to these banks, their customers, and their communities – keeping capital and resources focused where they are needed most.

In my statement, I would like to focus on the following points:

- Banks continue to lend in this difficult economic environment, but the broadening economic problems have already started to impact lending.

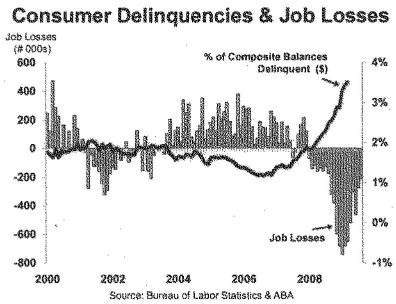
- The ability to lend is exacerbated by a regulatory environment that has tightened dramatically over the last year.

- Changes in the regulatory environment would improve the situation for small business lending.

I will address each of these points in turn. Before that, however, I did want to comment on a few key proposals for regulatory reform. While we share the same goals as the Administration, we continue to be particularly concerned about impact on small banks from the proposal to create a new Consumer Financial Protection Agency and the impact of eliminating the thrift charter. ABA is on record detailing our position on both of these, and many other key points of the Administration's proposals, so I will not elaborate on our concerns. Certainly, the banking industry fully supports effective consumer protection. But the proposal for a new consumer regulator, rather than rewarding the good banks that had nothing to do with the current problems, will add an extensive layer of new regulation that will take resources that could be devoted to serving consumers and make it more difficult for small community banks to compete. As I will detail below, these community bankers are already overwhelmed with regulatory costs and pressures that are slowly but surely strangling them. As you contemplate major changes in regulation – and change is needed – I urge you to ask this simple question: how will this change impact those thousands of banks like mine that did not create the problem and are making the loans needed to get our economy moving again?

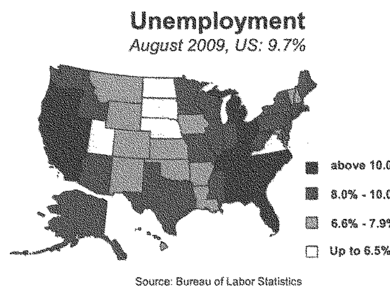
The regulatory restructuring that is being proposed would also eliminate the thrift charter – which are typically small institutions. This proposal would hurt thrift institutions that had nothing to do with the problems, does nothing to address the underlying problems, ignores the significant contributions made over decades to homeownership, and will only serve to confuse customers of thrifts and undermine confidence in banking. The ABA believes strongly that these important charters that have served our country well should be retained.

I. The Economic Environment is Already Affecting Demand for Loans



Source: Bureau of Labor Statistics & ABA

Since the recession began over 18 months ago, banks have continued to provide credit to their customers. The impact of the downturn, however, is being felt by all businesses, banking included. As the economy has deteriorated, it has become increasingly difficult for consumers and businesses to meet their financial obligations. This, in turn, has increased delinquencies at banks and resulted in losses. The impact of job losses on delinquencies is illustrated in the chart on the right. Job loss and other reductions or interruptions of income remain the number one cause of loan delinquencies and losses. In some states, the economies have been particularly hard hit, with unemployment levels state-wide significantly above the national average (see chart on state unemployment below).



Source: Bureau of Labor Statistics

For small businesses, the impact of job losses is also a huge problem. Moreover, individuals are saving more and buying less, which reduces foot traffic for retail and other businesses. As a consequence, business bankruptcies have risen from 28,000 in 2007 to more than 43,000 at the end of 2008. Those trends have continued into this year with 30,000 business failures already.[1]

Against the backdrop of a very weak economy it is only reasonable and prudent that all businesses – including banks and farms – exercise caution in taking on new financial obligations. Both banks and their regulators are understandably more cautious in today's environment. Bankers are asking more questions of their borrowers, and regulators are asking more questions of the banks they examine. This means that some higher-risk projects that might have been funded when the economy was stronger may not find funding today.

[1] These trends have meant that banks continue to experience losses and are also aggressively setting aside reserves to cover expected losses in the future given the severity of the recession. Setting aside reserves has reduced income and impaired earnings for banks. In fact, two out of every three institutions (64.4 percent) reported lower quarterly earnings than a year ago, and more than one in four (28.3 percent) reported a net loss for the quarter.

As mentioned, businesses are being very cautious and as a result, loan demand is down considerably. This is due, according to the National Federation of Independent Businesses (NFIB) to "widespread postponement of investment in inventories and historically low plans for capital spending." The NFIB reports that in spite of the difficult economic environment, 32 percent of businesses reported regular borrowing in August (down one point from July) compared to 7 percent who reported problems in obtaining the financing they desired (down 3 points). The NFIB also noted that only 4 percent of business owners reported "financing" as their number one business problem. This is extremely low compared with other recessions. For example, in 1983 – just after the last big recession – 37 percent of business owners said that financing and interest rates were their top problem.

Our expectation is that loan demand in this economy will continue to decline. Loan delinquencies and losses, which often lag the overall economy, will also continue to impact banks. Thus, realistically, the level of lending outstanding to all businesses will continue to decline for the rest of this year. However, as the economy starts to grow again and loan demand increases, the ability of banks to meet these needs will be stunted if adequate capital is not available to back increased lending.

We recognize that there are some consumers and businesses in the current situation that believe they deserve credit that is not being made available. This is not because banks do not want to lend – lending is what banks do. The current credit markets have tightened largely because of problems outside the traditional banking sector. In fact, because of these problems, the traditional banking sector will have to play an even larger role in providing credit to get the economy growing again. Banks are anxious to meet the credit needs of businesses and consumers, and we know that such lending is vital to an economic recovery in communities large and small across the country.

II. The Ability to Lend is Hurt by a Regulatory Environment That has Tightened Dramatically Over the Last Year

As I noted above, banks are not immune from the economic downturn, with job losses and business failures resulting in greater problem loans and much higher loan losses. Nonetheless, banks are working every day to make credit available. Those efforts, however, are made more difficult by regulatory pressures and accounting treatments that exacerbate, rather than help to mitigate, the problems.

Of course, the current regulatory environment is unquestionably impacted by concerns flowing from the economic downturn. A natural reaction of regulators is to intensify the scrutiny of commercial banks' lending practices. But just as too much risk is undesirable, a regulatory policy that discourages banks from making good loans to creditworthy borrowers also has serious economic consequences. Wringing out the risk from bank loan portfolios means that fewer loans will be made, and that only the very best credits will be funded.

Thousands of banks across the country did not make toxic subprime loans, are well-capitalized, and are ready to lend; but they cannot do so if misguided policies increase their regulatory costs and provide disincentives to lend. Banks already face significantly higher costs from increases in deposit insurance premiums. And banks are already receiving contradictory government signals about lending, being told to make new loans and, in some cases, being told by bank examiners not to increase lending because the risk is too great.

As this committee considers changes in the regulatory structure, it is very important not to create a conflict in policies – on one hand encouraging lending to help stimulate the economy and on the other hand discouraging lending through restrictive regulatory policies. This would be like spurring a horse to run faster while pulling back on its reins. Such conflicting efforts only waste resources and do not accomplish the goal of expanding lending to small businesses or individuals.

I'd like to detail some of the factors that are impeding greater bank lending:

FDIC premium payments are impacting banks' ability to make new loans

Perhaps the most immediate threat hampering banks' ability to make new loans is the very high premiums being paid by banks to the FDIC. There is no question that the industry fully backs the financial health of the FDIC. All the expenses of the FDIC for the last 75 years have been fully paid for by banks, not taxpayers. It is the healthy banks that are the survivors of any downturn that end up paying for the full cost of those banks that have failed. We do so because we know the importance of FDIC insurance to our customers and are committed to assuring they have that protection long into the future.

This year alone, the banking industry will be paying at least $17 billion to the FDIC. This includes regular quarterly payments as well as one special assessment of $5.6 billion paid in the second quarter. The FDIC may decide to impose another special assessment before the end of this year. Such large expenses have a very strong dampening effect on bank lending. Even the FDIC acknowledged in its release of its Quarterly Banking Profile for the second quarter that "earnings were also adversely affected by higher assessments for deposit insurance."

Covering the costs of the FDIC is one of timing. It is far better to pay off the costs of bank failures over time, rather than having huge assessments at the very time banks are struggling to preserve capital and keep costs down. Even if the FDIC were to draw on the Treasury's line of credit – which Congress enacted earlier this year with the full support of the ABA – banks would be fully responsible to repay that loan with interest. By repaying the expenses over a longer period of time, rather than having a huge payment all at once, banks are able to maintain needed resources that support bank lending in local communities.

Pressure on bank capital limit resources available for new loans

Capital is the foundation upon which all lending is built. Thus, having sufficient capital is critical to support lending. In fact, $1 worth of capital supports about $10 in bank assets (loans and securities). Fortunately, most banks entered this economic downturn with a great deal of capital. However, the downward spiral of the economy has forced losses on banks. Moreover, banks set aside a substantial amount of reserves for possible future losses.[2] The ABA continues to hear from bankers that the regulators are demanding increases in capital and that banks improve the "quality" of capital. This puts enormous pressure on banks to increase the relative importance of common stock. Typically, banks are able to raise capital to offset declines, even in a recession.[3] Unfortunately, the fragile and sometimes frozen financial markets have made this nearly impossible. Thus, with such pressure, the only course of action is to reduce lending in order to improve the bank's capital-to-assets ratio.

Some help to bolster capital came from the Capital Purchase Program (CPP), which was designed to provide capital to healthy banks (in contrast to non-CPP TARP money which was used to support troubled institutions, like AIG, General Motors and Chrysler). Unfortunately, the CPP suffered from misperceptions by the public about its purpose, and changes in the rules for participating banks hamstrung the program and discouraged greater participation. Moreover, the program originally focused on the largest banks, and was slow to roll out to others, particularly community banks. The result has been that many communities did not have as much credit available to them.

The changing nature of this program and the restrictive selection process has meant that banks that could have benefited from the program were unable to do so. Moreover, recent loss-share agreements entered into by the FDIC to attract investors in failed banks have the unintended consequence of creating incentives for private equity to wait until a bank fails rather than investing in the bank as a going concern. While these agreements may minimize the losses to the Deposit Insurance Fund, they nevertheless are making it harder for viable banks needing assistance to attract private equity.

As a result, to maintain reasonable capital levels, these banks have been forced to limit, or even reduce, their lending. The problem is even more acute for banks that are located in states with enormous economic problems. Many banks have been discouraged by their regulators to seek CPP or Capital Assistance Program (CAP) funding. This is having an impact on their banks and their customers. The ABA recommends that Treasury modify the criteria for its CAP to assist viable community banks that need help working through their current issues. We propose that Treasury offer assistance to those banks that did not qualify for CPP funds but that nevertheless can demonstrate the ability to operate safely and soundly if given the chance.

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[2] In the second quarter, banks set aside nearly $67 billion to cover losses expected in the future.

[3] In the past 6 recessions banks were able to add enough capital to ***raise*** the median capital-to-assets ratio by 70 basis points in the first 12 months since the start of the recession. However, in the first 12 months of this recession, banks' median capital-to-asset ratio ***declined*** by 104 basis points.

Supervisory responses to the crisis threaten to stifle new lending

Worsening conditions in many markets have strained the ability of some borrowers to perform, which often leads examiners to insist that a bank make a capital call on the borrower, impose an onerous amortization schedule, or obtain additional collateral. These steps can set in motion a "death spiral," where the borrower has to sell assets at fire-sale prices to raise cash, which then drops the comparable sales figures the appraisers pick up, which then lowers the "market values" of other assets, which then increases the write-downs the lenders have to take, and so on. Thus, well-intentioned efforts to address problems can have the unintended consequence of making things worse. Moreover, these actions can be completely counter to the notion of working with customers to make sure they have the credit they need and to work with those borrowers that may even be in distress.

We also have heard complaints from our members about examiners being inappropriately tougher in their analysis of asset quality and consistently requiring downgrades of loans whenever there is any doubt about the loan's condition. In some situations the examiners reportedly are requiring banks to increase reserves notwithstanding that the banks have written down the asset values in accordance with accounting practices (FAS 114). Clearly, economic conditions are worse today than a few years ago, and we understand that the examinations likely will be appropriately harder in many instances. However, the combination of inappropriate downward pressure on loan classifications and required higher reserves can cause a bank's capital position to worsen and further harm the condition of the bank.

While we appreciate the comments made by the heads of the federal banking agencies about finding the appropriate balance, the great challenge may be to ensure that regulatory personnel out in the field are applying the measured approach that has been expressed by the agency leadership. Increasingly, we are hearing troubling reports from our membership that regulatory mistakes of a decade ago are playing out again today. Such supervisory responses will only compound the problem we have today and make it much more difficult for banks to originate new loans.

Restrictions are acting to limit available funding sources for many banks

Banks cannot make loans if they lack adequate funding. There are several programs that enable banks to attract additional funding from core deposit customers. These programs include reciprocal deposit programs and sweeps from broker-dealers to their affiliated banks, and they enable banks to attract funds from core deposit customers. These deposit programs are designed to provide greater FDIC deposit insurance protection for customers, maintain the relationship between the bank and customer, and keep funds in the local community. The problem is that these deposits are lumped into the category of brokered deposits even though they have characteristics that more closely resemble "core" funding.

The problem arises due to the inability of banks to accept "brokered" deposits if it becomes less than well capitalized. However, the deposits obtained from reciprocal arrangements and sweep programs are volatile primarily because the statute, as implemented by the FDIC, creates the volatility. All banks, but particularly banks that are less than well capitalized, need to be able to attract and retain deposits from their core customer base. A rule that elevates form over substance impedes banks' ability to do so and, in turn, adversely affects the banks' ability to make loans.

Recent FASB rules will significantly reduce capital ratios and may devastate new lending

ABA is very concerned about new rules that have recently been promulgated by the Financial Accounting Standards Board.[4] Essentially, the new rules will require that the assets and liabilities of certain securitizations and variable interest entities be included on the balance sheets of some banks – even though these assets and liabilities do not belong to those banks. This "gross-up" of the balance sheet raises concerns about skewed financial ratios from a public reporting perspective, as well as the potential adverse impact on regulatory capital. If capital ratios are impacted, the ability of banks to make new loans is reduced.

ABA has urged the banking regulators to require that additional capital be held only for any incremental risk related to the assets and liabilities rather than a broad brushed assumption that the assets are available to the bank or its creditors. We also requested a transition period for any additional capital requirements of at least three years, with no capital impact in the first year.

The banking agencies have issued a proposal that would require capital to be held for all assets – including the new assets required to be consolidated under the new FASB rules. This translates into significant increases in capital for a number of banks, tying up dollars that could otherwise be placed in loans.

Proposals to mark-to-market loans will increase capital and reduce credit availability

Another accounting rule being considered would also impact the ability of banks to make new loans. For over 20 years there has been considerable debate about whether the accounting model should be based on market values. It is now being formally discussed as the new model for financial instruments, which is, effectively, banks' entire balance sheets. ABA agrees that if a bank's business model is based on buying and selling, then mark-to-market is appropriate. However, traditional banking is as an intermediary, taking in deposits and making loans, with earnings based on cash flows that are unrelated to buying and selling assets.

With mark-to-market, all loans – including healthy loans that have no credit deterioration – will be marked to market. The losses (and then subsequent gains and losses) will be flowing through the banks' financial statements and result in significant volatility that will not be tolerated by investors, regulators or independent bank directors. Volatile loan values will increase the cost of lending and reduce the availability of credit. The

[4] SFAS 166 and 167.

need for capital cushions will increase, increasing the cost of capital that will further reduce credit availability; product lives will be shortened; and, banks will begin to operate more like investment banks with a short-term trading mentality, instead of traditional banks governed by longer-term customer relationships.

Other regulatory rules have also limited banks ability to lend

Another issue of concern is the capital disincentives to robust provisioning for possible loan losses. Under the existing U.S. risk-based capital rules, reserves are included in regulatory capital only up to a specified percentage of risk-weighted assets. This fails to adequately recognize the loss-absorbing abilities of the entire allowance for loan losses and creates a disincentive to banks reserving more. Both the allowance for loan losses and "core" capital are available to absorb losses. Thus, these limitations create disincentives for banks to hold higher levels of reserves giving banks less loss-absorbing ability when times get tough.

An additional regulatory problem related to bank capital is that the risk weighting of debt issued by Fannie Mae and Freddie Mac is too high, meaning that banks are required to hold more capital than is necessary for the risk.[5] This means that capital that could be used to support additional lending is not available.

III. Changes in the Regulatory Environment Would Improve the Situation for Small Business Lending

What the regulators want for the industry is what the industry wants for itself: a strong and safe banking system. To achieve that goal, we need to remember the vital role played by good lending in restoring economic growth and not allow a credit crunch to stifle economic recovery. Commendably, the bank regulators are publicly encouraging lenders to work with their borrowers who are doing the right thing in good faith during these challenging times. But the current regulatory environment essentially precludes banks from being able to do that. We must work together to get through these difficult times. Providing a regulatory environment that renews lines of credit to small businesses is vital to our economic recovery.

Given the continued weakness in this economy and the challenges we will face in the next 18 months, it is a critical time to focus on strategies for helping community banks. ABA recommends that existing programs

[5] Prior to those institutions being placed into conservatorship, the debt was risk-weighted at 20 percent. Given the stated intent of the United States government to support these GSEs, a lower risk weight is appropriate and would help offset to a small degree the adverse impact that the conservatorships had on those banks that invested in Fannie and Freddie stock. The risk weight of GSE debt should be reduced to below 20 percent. The agencies proposed to lower the risk weight of Fannie and Freddie debt to 10 percent, but this rulemaking has been pending since October of last year and appears to be tangled in international discussions of capital weightings. We also support a comparable risk weighting for Federal Home Loan Bank debt and guarantees. This would provide parity of treatment and avoid unintended consequences for the Home Loan Banks and their members. Fannie Mae, Freddie Mac, and the Home Loan Banks engage in related housing finance missions, and the United States government has supported all three with comparable safety nets. To treat them in a dissimilar fashion ignores these fundamental similarities and will lead to the presumably unintended consequence of creating a perception that there is a greater degree of risk inherent in Home Loan Bank debt.

be expanded, particularly designed to help community banks. Several key changes that are needed include broadening capital programs to enable participation by a broader cross-section of banks (particularly community banks that are viable but are struggling in communities most hard hit by the recession) and avoiding appraising banks into insolvency by using inappropriately conservative asset valuations and underwriting standards.

Broaden capital programs to enable participation by a broader cross section of banks

As I emphasized at the outset, the amount of capital required to provide an additional cushion for all community banks is small. For instance, $5 billion of TARP money specifically for community banks, when matched by private equity on a dollar-for-dollar basis, would be sufficient to bring all insured depository institutions with assets under $5 billion to capital levels equal to a Tier 1 risk-based capital ratio of 8 percent and a total risk-based capital ratio of 12 percent assuming the stressed scenarios used by the banking regulators in the stress testing under the Supervisory Capital Assessment Program (SCAP). These capital levels significantly exceed the thresholds established by the banking regulators for a bank to be deemed "well capitalized" under the Prompt Correct Action rules and would provide a cushion that could enable participating banks to continue meeting the credit needs of their communities without having to shrink to comply with minimum regulatory capital requirements.

As noted above, the CPP has been implemented in a way that ignores community banks that are viable but that are experiencing significant – yet temporary – problems. The Capital Assistance Program (CAP) has not yet been implemented for community banks, but reportedly will apply the same eligibility criteria that have been used with the CPP. The Legacy Loans Program has the potential to help, but the FDIC recently announced a delay in implementing the Legacy Loans Program that calls into serious question its viability outside the possible use in failed bank situations. The Legacy Securities Program is still struggling to get off the ground as well. Program after program either has failed to meet the needs of viable community banks or has languished.

ABA believes that this problem can be solved through several modifications of the CAP:

1. Permit banks with up to $5 billion in total assets to participate in the CAP.
2. Provide funding to viable banks that have significant – yet manageable – issues. Viability could be demonstrated by the ability of a bank to attract private equity that would be willing to match Treasury's investment and accept an interest that is subordinate to that given to Treasury.
3. Revive the Legacy Loans Program and implement the Legacy Securities Program in a way that expands the universe of eligible assets to include trust preferred securities, "real estate owned," and other real estate-related loans. The programs also should be implemented in a way that avoids effectively shutting small banks out (for example, by requiring minimum sizes on asset pools that no community bank could meet).

The comparatively small sums of money that would be invested in these struggling but viable banks would pay big returns for the communities they serve.

Avoid appraising banks into insolvency by using inappropriately conservative asset valuations and underwriting standards

ABA believes there are several steps that the regulators should be taking to remedy this situation and we urge this committee to use its oversight authority to encourage them to issue written guidance affirming that banks should not use distressed sales values when analyzing "comparables" and apply clear and consistent standards for a banks' loss reserve that reflect a realistic assessment (based on the current accounting standards) of the assets' likely performance.

These changes are necessary to confront the natural inclination of examiners to be conservative in order to avoid the inevitable second-guessing that would arise if a bank were to fail on their watch. We are not suggesting that examiners use forbearance or otherwise relax their examination standards; rather, we are suggesting that the examiners not be harder on banks than circumstances warrant. The regulators can make things worse in their efforts to make things better. Insisting upon punitive, pro-cyclical steps at a time when a bank is working through issues can push an otherwise viable bank over the edge.

Enact comprehensive regulatory reform

Since last fall, in hearings like this and elsewhere, ABA has called for comprehensive regulatory reform including many issues covered in the Administration's proposal. We believe regulatory reform is badly needed, and Congress should move to adopt such reforms. ABA has testified in favor of creating a systemic regulator, providing a mechanism for resolving troubled firms deemed "too big to fail," closing gaps in the regulation of non-banks and improvements in consumer protection. We will continue to strongly advocate for legislation that focuses on these critical issues and are committed to working with the Administration, Congress and our regulators to enact strong – and effective – reform legislation.

While ABA, like key members of Congress and the regulators, has suggestions for improvements, we are in general agreement of the need for comprehensive reform in the broad areas the Administration has targeted. Among the recommendations ABA is making are to avoid an expansive new bureaucracy for consumer issues that would conflict with the prudential regulator, maintaining the thrift charter and strengthening the resolution mechanism.

Conclusion

I want to thank you, Madam Chairwoman, for the opportunity to present the views of the ABA on the challenges ahead for the banks that serve small businesses. These are difficult times and the challenges are significant. In the face of a severe recession, however, bankers are working hard every day to ensure that the credit needs of our communities are met. As you contemplate major changes in regulation – and change is needed – ABA would urge you to ask this simple question: how will this change impact those thousands of banks that make the loans needed to get our economy moving again? Addressing these issues will provide the most constructive avenue to ensure that communities throughout this nation will continue to have access to credit by local financial institutions.

Thousands of banks of all sizes, in communities across the country, are scared to death that their already-crushing regulatory burdens will be increased dramatically by regulations aimed primarily at their less-regulated or unregulated competitors. Even worse, the new regulations will be lightly applied to non-banks while they will be rigorously applied – down to the last comma – to banks.

We look forward to working with Congress to address needed changes in a timely fashion, while maintaining the critical role of our nation's banks.

ICBA
INDEPENDENT COMMUNITY
BANKERS *of* AMERICA

Testimony of

James D. MacPhee
Chief Executive Officer
Kalamazoo County State Bank
Schoolcraft, Michigan

On behalf of the
Independent Community Bankers of America

Before the

United States House of Representatives
Committee on Small Business

Hearing on

"The Impact of Financial Regulatory Restructuring on Small Business"

September 23, 2009
Washington, D.C.

Chairwoman Velazquez, Ranking Member Graves, Members of the Committee, my name is James MacPhee. I am CEO of Kalamazoo County State Bank in Schoolcraft Michigan and chairman-elect of the Independent Community Bankers of America[1]. Kalamazoo County State Bank is a state-chartered community bank with $77 million in assets. I am pleased to represent community bankers and ICBA's 5,000 members at this important hearing on "The Impact of Financial Regulatory Restructuring on Small Business."

The timing of this hearing is most appropriate. Just over one year ago, due to the failure of some of our nation's largest institutions to adequately manage highly-risky activities, key elements of the nation's financial system nearly collapsed. Other parts – especially our system of locally owned and controlled community banks – were not in similar danger. But community banks and small businesses -- the cornerstone of our local economies -- have suffered as a result of the financial crisis and the severe recession caused by mega-banks and unregulated financial players.

In my state of Michigan, we face the nation's highest unemployment rate of 15.2 percent. The state shed another 43,000 payroll jobs in August. Yet community banks like mine stick to common-sense lending and serve our customers and communities in good times and in bad. The bank has survived the depression and many recessions in its more than 100-year history and it proudly serves the community through this financial crisis.

ICBA is adamant that any financial regulatory reform not harm community banks' ability to continue supporting small businesses. Small businesses are the engines of our economy and rely on a steady flow of credit. The excesses of giant financial firms were the key cause that destabilized the markets and small business access to credit. Any reforms must target the too-big-to-fail and systemically risky firms, as well as the unregulated non-bank financial firms operating in the shadows, if another financial crisis and economic meltdown is to be averted.

Summary of Testimony

- While many mega-banks have pulled in their lending and credit, the nation's community banks are lending leaders that continue to support small business.
- The financial crisis was caused by a few bad actors and not by well-capitalized, highly-regulated, common-sense community banks. Therefore, financial reform must "first do no harm" to the reputable financial players and the job-creating small business sector seeking credit.

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[1] *The Independent Community Bankers of America represents nearly 5,000 community banks of all sizes and charter types throughout the United States and is dedicated exclusively to representing the interests of the community banking industry and the communities and customers we serve. ICBA aggregates the power of its members to provide a voice for community banking interests in Washington, resources to enhance community bank education and marketability, and profitability options to help community banks compete in an ever-changing marketplace.*

With nearly 5,000 members, representing more than 18,000 locations nationwide and employing over 268,000 Americans, ICBA members hold more than $908 billion in assets, $726 billion in deposits, and more than $619 billion in loans to consumers, small businesses and the agricultural community. For more information, visit ICBA's website at www.icba.org.

- Reforms must be carefully targeted at the root causes of the crisis which were the exotic risk-taking and excessive leverage of too-big-to-fail firms, and abuses perpetrated by unregulated institutions. Regulatory restructuring and consumer protection policy cannot indiscriminately layer additional and redundant regulation on the entire financial sector like a wet blanket smothering banks' ability to supply small business credit. Proposed new consumer protections should focus on the unregulated players and institutions and not community banks. ICBA strongly opposes proposals that would completely strip rule writing and supervision for community banks from agencies that also must take safety and soundness into account.

- Addressing too-big-to-fail financial firms, systemically risky firms, and unregulated financial firms is the key to a stable financial sector that can support small business. Financial regulatory reform must eliminate the too-big-to-fail moral hazard once and for all, identify institutions that potentially pose systemic danger and ensure these firms are subject to substantially higher capital and liquidity requirements, plus more rigorous supervision.

- Reform should grant receivership, conservatorship and bridge bank authority to the FDIC to operate an insolvent systemically risky institution and develop a restructuring, downsizing or dissolution plan. Taxpayers should not be held hostage to prop up too-big-to-fail financial firms.

- A diverse and competitive financial system with regulatory checks and balances will best serve the needs of small business. Any financial reform must retain the dual banking system of federal and state bank chartering and not create a single, monolithic federal regulator. It would be too risky to our national and local economies to empower only a single agency with all bank regulatory authority.

- The massive over-concentration of financial assets in just a few firms must end. Reform should reduce and strengthen the 10% nationwide deposit concentration cap established by the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994.

- Financial reform should impose a systemic risk premium on all "Tier I" financial holding companies, broadly defined to include all large complex financial firms that have the potential of posing a systemic risk. All FDIC-insured affiliates of large complex financial firms should pay a systemic risk premium to the FDIC in addition to their regular FDIC premiums to compensate the FDIC for the increased risk they pose.

- FDIC deposit insurance premiums should be assessed fairly to reflect a bank's true risk. ICBA recommends the assessment base used by the FDIC include total assets minus tangible equity for the assessment base, rather than domestic deposits.

- Financial reform should establish an Assistant Treasury Secretary for Community Financial Institutions to help policymakers better understand the nation's 8,000-plus community banks.

Focus Financial Reform on Firms that Sparked Crisis
Financial regulatory reforms are needed to help ensure a financial and economic meltdown of massive scale can be avoided in the future. ICBA is pleased the Administration and Congress has advanced reform proposals that include many of ICBA's principles. However, in pursuing financial regulatory change we must ensure these reforms are carefully targeted at the root causes of the crisis which were the exotic risk-taking and excessive leverage of too-big-to-fail firms, and abuses mainly perpetrated by unregulated institutions.

The financial crisis, as you know, was not caused by well-capitalized, highly-regulated, common-sense community banks. Community banks are relationship lenders and do right by their customers. Therefore, financial reform must "first do no harm" to the reputable financial actors and job-creating small business sector seeking credit. Financial restructuring must support robust small business lending, not jeopardize community banks' ongoing ability to supply business credit. For that reason, misplaced, unduly burdensome and onerous new regulations on community banks must be avoided.

This financial crisis, and the havoc it wreaked on small businesses nationwide was caused by the excesses of a few firms that over the years have been allowed to greatly concentrate the nation's financial assets or fly under the radar of bank regulation altogether. So reforms must be focused on these specific entities. Just a few unmanageable financial entities, not the nation's 8,000 community banks, nearly destroyed our equity markets, our real estate markets, our consumer and small business loan markets, the global finance markets and cost the American consumer over $7 trillion in net worth. The resulting crisis held taxpayers hostage and caused the federal government to inject almost $10 trillion in capital and loans and guarantees to large complex financial institutions whose balance sheets were not transparent, over-leveraged and lacked adequate liquidity and capital to offset the risks they had taken.

The crisis was driven by the anti-free market logic of allowing a select few firms to concentrate unprecedented levels of our nation's financial assets and exist even as they became too big to fail. Unfortunately, a year after the credit crisis was sparked, too-big-to-fail institutions have gotten even bigger. Today just four mega-firms control nearly half of the nation's financial assets. This is a recipe for future disaster and not in the best interest of small businesses and the economy.

Congress has already passed legislation at great cost to the taxpayers intended to deal with the financial crisis and the deep recession. The credit markets have stabilized and the economy is beginning to turn the corner toward recovery. Now is the critical period to ensure the lessons of this financial crisis are not forgotten. Financial reform must reduce the chances that risky and irresponsible behavior by large or unregulated institutions can again spark economic ruin.

Small businesses depend on a reliable and steady flow of credit to survive and grow their businesses and to create jobs. ICBA believes small businesses will lead the nation in our economic recovery. ICBA commends the Small Business Committee for this hearing to address the important task of financial regulatory reform.

Small Business and Community Banks Key to Recovery
Small businesses need steady access to credit to fuel our economy. Small businesses represent a whopping 99% of all employer firms and employ half of the private sector workers. The more than 26 million small businesses in the U.S. have created 70 percent of the net new jobs over the past decade. With the unemployment rate reaching 9.7 percent, the viability of small businesses is more important than ever. ICBA believes the key to successful financial reform should be to establish a more stable and uninterrupted flow of credit to fuel the creation of new small businesses and the viability and growth of existing ones.

Community Banks are Major Small Business Lenders
Community banks are small businesses too and are essential to the success of small firms nationwide. Community banks specialize in small business relationship lending. Community banks stick with their local communities and small business customers in good times and in bad. Community banks serve a vital role in small business lending and local economic activity. For their size, community banks are disproportionately large small business lenders. While community banks represent about 12% of all bank assets, they make 31% of the dollar amount of all small business loans less than $1 million. Notably, half of all small business loans under $100,000 are made by community banks.

Community Banks Helping the Economic Recovery
While many mega-banks have pulled in their lending and credit, the nation's community banks are lending leaders. According to an ICBA analysis of the FDIC's most recent FDIC's Quarterly Banking Profile, community banks with less than $1 billion in assets were the only segment of the industry to show growth in net loans and leases in Q2 2009 on both a quarterly and annual basis.[2] In aggregate, these institutions had 0.8 percent annualized growth over the previous quarter and 3.2 percent growth over a year earlier.

Additionally, these community banks led the industry with 4.5 percent annualized growth in domestic deposits on a quarterly basis and 8.3 percent over the previous year. According to the FDIC report, a higher percentage of community banks were profitable in the second quarter compared to the industry overall. Institutions with less than $1 billion in assets remained the best-capitalized in the industry, with a leverage ratio of 9.75 percent. Credit quality was also better at banks with less than $1 billion in assets, with net charge-offs to loans of 1.08 percent and noncurrent loans at 3.11 percent. Both were lower than the industry average by more than a percentage point. Community banks' consistent lending in their local communities contributes to the continued stability and strength of the small business sector.

Conversely, large systemically risky financial firms and too-big-to-fail institutions can still knock our entire financial system out of whack. Without a stable financial market going forward and steady access to credit, the viability of small businesses and our standard of living are jeopardized. The Administration's financial reform plans take important steps toward addressing systemic risks posed by too-big-to-fail financial firms. ICBA offers detailed recommendations to make them even stronger.

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[2] Federal Deposit Insurance Corporation. *Quarterly Banking Profile*, Second Quarter, 2009.

Reforms Are Needed
It was just over a year ago that the collapse of Lehman Brothers helped trigger a credit crisis that crippled the economy. It is critical to remember that taking measures to reduce systemic risk and eliminating too-big-to-fail today is the best way to protect consumers and small businesses going forward. Millions of Americans have suffered economic hardship, lost their jobs, their savings and their homes as a result of the financial crisis. Small businesses have to deal with both dramatically weaker demand and more challenging access to credit. In order to prevent a similar meltdown and to stabilize the flow of small business demand and credit, targeted financial reforms make sense. ICBA believes proposed reforms and consumer protections must be carefully targeted to those who sparked this crisis and perpetrated abuses, so not to add unnecessary and redundant burdens on those institutions that have always treated their customers with respect and fairness.

Addressing Systemic Risk
ICBA supports President Obama's plan to identify specific institutions that may pose systemic risk and to subject them to stronger supervision, capital, and liquidity requirements. Our economy needs more than an "early warning" about possible problems; it needs a real cop on the beat.

But the President's plan could be enhanced to better protect the taxpayers and safeguard the financial system. ICBA believes that systemically risky holding companies should pay upfront fees for their supervisory costs and to fund – in advance – a new systemic risk fund. The President's plan calls for funding only after an institution fails.

ICBA also strongly supports the "Bank Accountability and Risk Assessment Act of 2009" introduced by Rep. Luis Gutierrez (H.R. 2897) which would require the FDIC to impose an additional fee on any insured bank affiliated with a systemic risk institution. This would better account for the risks these institutions pose and strengthen the Deposit Insurance Fund. ICBA thanks the many cosponsors of this important reform and urges all members to support this sensible measure as part of any financial reform package.

These strong measures are not meant to punish those institutions for being large, but to guard against the risks they pose and to protect the taxpayers and the public. They would hold these large institutions accountable and discourage them from remaining or becoming "too-big-to-fail." However, if these enhancements are not enough, the President's plan sensibly calls for a plan to resolve failing institutions. Our testimony details how Congress can further improve the plan.

But to truly prevent the kind of financial meltdown we faced last fall, and to truly protect consumers, the plan must go further. It should direct systemic risk authorities to develop procedures to downsize the too-big-to-fail and systemically risky institutions in an orderly way.

ICBA is pleased that the Administration's plan maintains the state banking system and believes that any final bill should also maintain the thrift charter. Both charters enable community bankers to follow business plans that are best adapted to their local markets and pose no systemic risk.

Protecting Consumers
Community banks are in a relationship business with their local customers and rely on honest and respectful service for their survival. Community banks are one of the most highly-regulated and supervised industries. However, unregulated individuals and companies offering financial services were in a position to abuse millions of American consumers. And it is these players that must be the focus of any proposed new consumer protections. Community banks already do their utmost to serve consumers and comply with consumer protections. Therefore, ICBA strongly recommends that before massive consumer protection reforms are considered, any new legislation should ensure that otherwise unregulated or unsupervised people and institutions are following existing law. We strongly believe that supervision for community banks should remain with agencies that also must take safety and soundness into account. Safety and soundness regulators should also be equal partners in rule writing. Clearly a financial institution that does not adhere to consumer protection rules also has a safety and soundness problem.

Proposed CFPA
Community bankers agree that consumer protection is a cornerstone of our financial system. However, ICBA has significant concerns with the proposed Consumer Financial Protection Agency (CFPA) as crafted. Such a far-reaching expansion of government can do more harm than good by unduly burdening our nation's community bankers who did not engage in the deceptive practices targeted by the proposal. It could jeopardize the availability of credit and choice of products and shrink business activity.

ICBA has heard loud and clear from its members that they are opposed to another additional regulator and a plan that could jeopardize their ability to offer cost-effective, customized products to meet the specific needs of their customers. The success of community banking depends on superior customer service and specialized products consumers may not get with the competition. This higher level of customer service, combined with more customized terms and conditions on financial products is, at the end of the day, what makes any community bank a viable enterprise. The existing regulatory framework, while often costly to a fault, allows community bankers to ensure their customers are fully informed and educated of their choices, while also allowing the bank to operate in a safe and sound manner.

To be sure, community banks prefer to offer consumers simpler products when it is appropriate; but "simpleness" as a doctrine should not be promoted at the expense of all other products. Not every consumer's situation is best served by the simplest product. This proposed CFPA does not reflect the nature of community banking, particularly the emphasis community bankers place on maximizing long-term relationships with their customers. It is a one-size-fits-all prescription that will add significant costs to small banks.

Because community banks are so closely tied to their local economies, the success or failure of a community bank depends on its ability to know and encourage what is in the best interest of its customers. As an example, many community banks have been offering balloon loans for decades. These loans were the only product that many rural, underserved, or otherwise risky consumers could possibly qualify for, so they extended the credit. However, community banks could not turn around and sell or securitize these loans because they do not meet secondary market criteria, instead keeping them on their books, maintaining all of the risk and all of the incentive to ensure those consumers met their obligations. The proposed CFPA would make it costly, burdensome, and a bureaucratic nightmare for a community bank to do that in the future. Requiring banks to offer less diverse financial products limits the ability of many consumers to gain access to credit, and will unintentionally create an economic environment catering to higher-income consumers who possess greater economic flexibility.

ICBA believes the regulatory and enforcement powers shifted to the CFPA would unwisely separate consumer protection from safety and soundness enforcement, when both types of enforcement must co-exist under one agency for efficient financial services regulation. Separating this enforcement among two different agencies would only give each agency half of the information it would need. If the CFPA is not equally interested in the safety and soundness of the lender, it is likely to promulgate burdensome regulations that make many currently safe financial products, which are beneficial to consumers but might be considered complicated, unavailable or too costly to offer. Furthermore, this lack of perspective could lead to the CFPA issuing directives that compete or run contrary to those issued by the prudential regulator. A community bank could find itself in a position with two conflicting mandates, each of which must be followed, with no clear means of resolution.

ICBA urges Congress to focus the CFPA-type reform on the lack of oversight of non-bank entities – which were at the heart of the current crisis – not on increasing regulation of community banks. ICBA believes this is the best way to avoid future abuse in the marketplace and to stabilize credit for all individuals and businesses. Creating yet another agency and layer of bureaucracy for community banks that are already heavily examined and regulated, is not. ICBA believes that the examinations regularly conducted by bank regulatory agencies are the best means to ensure compliance with consumer protection requirements established by statute and regulation.

Improving Financial Policy Making

Since the onset of the thrift crisis in the late 1980s, the Treasury Department's role in policy making for financial institutions has grown substantially. Before that time, it was more focused on broad national and international financial markets; the executive branch generally left financial institutions policy making to the various supervisory agencies. ICBA urges Congress to update the Treasury's organizational structure to add an assistant secretary for community financial institutions to provide an internal voice for Main Street concerns. The "Administrative Support and Oversight for Community Financial Institutions Act of 2009" (H.R. 2676) introduced by Rep. Dennis Cardoza will provide that important balance between Wall Street and Main Street within the Treasury.

Maintain the Dual Banking System and Federal Regulatory Structure

ICBA is pleased that the President's plan retains the system of federal and state bank chartering and does not recommend creating a single, monolithic federal regulator. The current system of bank supervision – though admittedly complicated on paper, has weathered the current crisis reasonably well. It provides substantial uniformity of capital and supervisory standards, but also different perspectives and essential checks and balances.

Some have complained that these advantages also give institutions the opportunity to engage in "regulatory arbitrage," playing one regulator against another. Let me be completely clear on this, no institution should be able to escape a regulatory action, such as a cease and desist or similar order, by changing charters. In fact, the Federal Financial Institutions Examination Council recently issued a statement that provides "that charter conversions or changes in primary federal regulator should only be conducted for legitimate business and strategic reasons." It goes on to say that, "Conversion requests submitted while serious or material enforcement actions are pending with the current chartering authority or primary federal regulator should not be entertained." [3]

Retain the Federal Thrift Charter; Subject Unitary Thrift Holding Companies to the BHCA; Close ILC Loophole

The federal thrift charter must be maintained. The U.S. financial system benefits from a charter dedicated to housing and consumer lending. Certain large banking institutions intent on engaging in risky, nontraditional banking activities used a thrift charter to do so, but this was not the fault of the charter but of the business plan of those institutions. Unlike Washington Mutual or Countrywide Financial, most thrift institutions are well-run community institutions that are heavily engaged in making prime residential mortgage loans in their communities and were never engaged in subprime, interest-only or other types of alternative residential mortgage lending.

The Office of Thrift Supervision should be retained since we need a regulator that has the expertise to supervise and regulate institutions like thrifts and mutual institutions that focus on housing lending. If the OTS is merged into the proposed National Bank Supervisor, then at a minimum, existing federal thrift charters should be preserved or grandfathered, and a Division of Thrift Supervision should be established within the NBS to regulate institutions that want to maintain their federal thrift and mutual institution charters. For example, it would be a substantial hardship for existing mutual institutions organized as federal thrifts to convert to commercial bank charters. This could force some of them to convert to stockholder-based entities. No mutual institution should be pressured into converting or denied the option of mutuality.

We agree that unitary thrift holding companies should be regulated as bank holding companies, supervised and regulated by the Federal Reserve on a consolidated basis, and subject to prohibitions on commercial activities. Many commercial entities used the unitary thrift loophole to get into the banking business. Unfortunately, the Gramm-Leach-Bliley Act of 1999 grandfathered existing thrift holding companies that qualified as unitary thrifts. By escaping the Bank Holding Company Act, these unitary thrifts have been able to evade consolidated supervision by the Federal Reserve and the long-standing policy of separating banking from commerce. This loophole should be shut down and unitary thrifts should be given a definite period of time to divest their commercial activities once they become subject to the Bank Holding Company Act.

[3] **FFIEC Statement on Regulatory Conversions;** FIL-40-2009, July 7, 2009

Of course, the same must be said about the industrial loan company (ILC) loophole, which remains open. Under this loophole, commercial companies may acquire or establish banks in several states. Administrative action and economic conditions have discouraged this activity in recent months, but unless the Congress acts, commercial companies could soon begin seeking banking charters again. Just imagine if major commercial firms had been heavily involved in the banking business last fall. The Administration has proposed the safest course – close the ILC loophole in connection with reform legislation.

Enhance Systemic Risk Regulation

The Administration's proposal expands the authority of the Federal Reserve to supervise all institutions that could pose a threat to financial stability, including non-banks, and creates a Financial Services Oversight Council to identify emerging systemic risks in firms and market activities and improve interagency cooperation. These proposals are a substantial improvement over the current system, but can be improved to truly protect consumers, local communities and small business's steady access to stable credit markets.

Make the Federal Reserve the Primary Systemic Risk Regulator

Our nation needs a strong and robust regime of systemic risk regulation and oversight. The financial meltdown on Wall Street revealed that reckless lending and leveraging practices by a few too-big-to-fail institutions were the root of the current economic crisis. The only way to maintain a vibrant banking system where small and large institutions can fairly compete – and to protect taxpayers – is to aggressively regulate, assess and eventually downsize institutions that pose a risk to financial stability.

ICBA supports the President's proposal to designate the Federal Reserve as the primary systemic risk regulator. The Federal Reserve is the agency best equipped to take on this new role. However, ICBA shares the concerns expressed by some in Congress that without proper direction and oversight, the Fed may be slow or reluctant to act to address systemic risks. Some Members of Congress have justifiably criticized the Fed for its slow response to the congressional mandate to promulgate new rules to govern the unregulated segments of the mortgage industry or for its promotion of the Basel II capital agreement. Indeed, one of the weaknesses of the Administration's proposal is that the Federal Reserve is given too much new power with no accountability for enforcement.

Enhance Duties of Council

Therefore, the proposed Financial Services Oversight Council should have the power to set clear policy and have oversight authority over the Federal Reserve, including establishing capital, liquidity and other requirements for systemic risk firms, the power to overrule Fed decisions by a majority vote of the Council, and the power to force the Fed to take actions. In addition, the Fed should be required to report to Congress on a regular and frequent basis, so that Congress can also exercise oversight to ensure that the Fed is properly and appropriately implementing its new authority.

The Council should be responsible for identifying gaps in regulation and recommending institutions that should come under consolidated supervision by the Federal Reserve. It is critical to extend supervision and oversight to those non-bank entities that contributed to the current financial crisis largely because they did not fall under any agency's regulatory umbrella.

Identify Systemic Risk Institutions

Generally speaking, systemic risk institutions are Large Complex Financial Institutions (LCFIs) that are sufficiently large that diversification no longer mitigates risk. Instead, their risk profiles increasingly come to resemble that of the financial market itself, leaving them vulnerable to any major shock to the financial markets.

When companies like Morgan Stanley and Goldman Sachs and Lehman Brothers are leveraged 25 to 34 to one, when they have less than four cents at risk for every dollar in assets, their success or failure determines the future of the markets. According to Bridgewater Financial Group (HBR August 2009)[4] in September of 2008 the Bank of America was leveraged 73 to 1 and if it were to capitalize all of its off balance sheet entities it would have been leveraged 134 to 1. That means less than 1 penny of capital at risk for every dollar of assets.

Congress and the Council must establish clear principles to identify systemic risk institutions. It is not difficult to identify the handful of mega-bank financial institutions which will form the core of the proposed Tier 1, but at the margins, defining systemically important institutions by asset size alone is insufficient. Institutions that are not systemically risky may become so through growth or complexity. Flexibility ensures that the systemic risk regulator can respond to changes in the market, but they should always operate under clearly articulated principles.

Some contend that Tier 1 institutions should not be publicly identified because that would give them an unfair advantage in the marketplace. We disagree. Institutions that potentially pose systemic risk must be identified. Supervision by specific regulators and the enforcement of any rules designed for systemic risk institutions might make this obvious anyway. Status as Tier 1 should not be a signal to markets that an institution will not be allowed to fail, but rather that its failure would raise systemic concerns.

The fundamental purpose would be to make clear that these institutions will be subject to substantially higher capital and liquidity requirements, plus more rigorous supervision in order to protect the financial system and the economy. This will help mitigate any "advantage" they might receive. In addition, more liquidity and better supervision will decrease the chance that an institution will fail in the first place. And, in the event of failure, higher capital will protect taxpayers.

Systemic Risk Guidelines

ICBA suggests as a guideline that a systemic risk financial institution is one that has more than $100 billion in assets, and has a risk profile that is susceptible to one or more risk factors. While not all institutions with more than $100 billion in assets are by definition systemically significant, all institutions in excess of $100 billion in assets should be examined more closely to determine their systemic importance with special attention paid to the following factors:

[4] Harvard Business Review, August 2009

- Provision of systemically essential services within the economy.
- Use of leverage – both traditional and embedded in derivatives.
- Status as a major client and/or counterparty of LCFIs.
- Overall level of participation/integration with capital markets, especially high risk activities such as proprietary trading activities.
- Extensive trading in derivative instruments which can potentially multiply risk exposures as well as mitigate, especially writing of derivatives contracts.
- Dependence on short-term non-depository funding from capital markets such as commercial paper.
- Rate of asset growth.
- Deposit concentration.
- Off balance sheet activities.
- Organizational complexity and capability of management.

Allow FDIC Sole Resolution Authority

Too-big-to-fail remains a cancer on our financial system. Even after the financial crisis, too-big-to-fail risk is increasing, as the very largest financial firms are getting even larger. We must take measures to end too-big-to-fail by ensuring there is a mechanism in place to declare an institution in default and appoint a conservator or receiver that can unwind or sell off the institution's operations in an orderly manner. To maintain market discipline, as part of the process shareholders and management responsible for the institution's demise should not be protected. The Federal Reserve, in consultation with the Council, must have the authority to declare an institution insolvent when capital falls below an established level and the institution cannot raise new private capital. Agencies insulated from politics – not the Treasury as proposed by the Administration – should make these calls.

We strongly support the Administration's proposal to grant receivership, conservatorship and bridge bank authority to the FDIC to operate an insolvent systemically risky institution, including its holding company and affiliates, and develop a restructuring, downsizing or dissolution plan. The FDIC, should have sole authority to determine how a systemically risky institution should be resolved. The FDIC has extensive experience resolving banks and has the infrastructure in place to exercise conservatorship and receivership powers over financial companies.

The FDIC should have clearer guidelines than provided in the Administration's plan for resolving failing Tier 1 institutions leading to restructuring and downsizing through sales of assets. At a minimum, Tier 1 financial holding company shareholders should not be protected.

Government must re-establish credibility that shareholders of financial institutions will bear the full loss in any insolvent financial institution. This core principle of capitalism has been repeatedly violated or in the often cited words of Allan H. Meltzer[5], "Capitalism without failure is like religion without sin – it doesn't work."

Require Insolvency Contingency Plan

As the Lehman Brothers failure demonstrated, subverting market expectations, especially too-big-to-fail expectations, can be extremely destabilizing – therefore a clear, rules-based process must be followed. Tier 1 FHCs should have an insolvency contingency plan which the resolution authority can use in the event of failure. This plan should include close monitoring of their counterparty exposures for possible spillover effects. Regulators should ensure systemic risk institutions are organized so they can continue to perform systemically important functions during a resolution process.

How to End Too-Big-To-Fail

Ending too-big-to-fail is one of the most critical issues facing our nation. If a firm is too-big-to-fail it should be deemed too-big-to-exist. The only way to truly protect consumers, small businesses, our financial system, and the economy is by finding a solution to rein in too-big-to-fail institutions. One of the weaknesses in the Administration's proposal is that it assumes special treatment for Tier 1 FHCs, which could result in the perpetuation of the too-big-to-fail doctrine. One of the goals of any regulatory restructuring plan should be to eliminate too-big-to-fail so the future failure of a systemic risk institution would not threaten the stability of our economic system.

Indeed, implicit in the FDIC's role in resolving insolvent institutions is the end of the too-big-to-fail doctrine, which has driven the creation of systemic risk institutions and given too-big-to-fail institutions an unfair competitive advantage.

In a recent speech, Federal Reserve Chairman Ben S. Bernanke outlined the risks of the too-big-to-fail system:

> [T]he belief of market participants that a particular firm is considered too-big-to-fail has many undesirable effects. For instance, it reduces market discipline and encourages excessive risk-taking by the firm. It also provides an artificial incentive for firms to grow, in order to be perceived as too big to fail. And it creates an unlevel playing field with smaller firms, which may not be regarded as having implicit government support. Moreover, government rescues of too-big-to-fail firms can be costly to taxpayers, as we have seen recently. Indeed, in the present crisis, the too-big-to-fail issue has emerged as an enormous problem.[6]

FDIC Chairman Sheila Bair, in remarks before the ICBA annual convention in March 2009, said, "What we really need to do is end too-big-to-fail. We need to reduce systemic risk by limiting

[5] University Professor of Political Economy at Carnegie Mellon University, and Visiting Scholar at the American Enterprise Institute, author of *A History of the Federal Reserve, Volume 1: 1913-1951*
[6] Financial Reform to Address Systemic Risk, at the Council of Foreign Relations, March 10, 2009

the size, complexity and concentration of our financial institutions." [7] "To guard against excessive concentration in national banking systems, with implications for effective official oversight, management control, and effective competition, nationwide limits on deposit concentration should be considered at a level appropriate to individual countries."[8]

Strengthen Deposit Concentration Cap

The 10% nationwide deposit concentration cap established by the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 must be immediately reduced and strengthened. The current cap is insufficient to control the growth of systemic risk institutions the failure of which will cost taxpayers dearly and destabilize our economy.

Unfortunately, government interventions necessitated by the too-big-to-fail policy have exacerbated rather than abated the long-term problems in our financial structure. Through Federal Reserve and Treasury orchestrated mergers, acquisitions and closures, the big have become bigger.

Downsize Systemic Risk Institutions

Congress should make clear that downsizing of systemic risk institutions is not only desirable, it is essential if we are to avoid future financial calamities. It is clearly not in the public interest to have so much power and concentrated wealth in the hands of so few, giving them the ability to destabilize our entire economy.

The Administration's plan includes valuable incentives to encourage downsizing. ICBA strongly supports the Administration's proposal to subject "Tier 1" FHCs to stricter and more conservative prudential standards than those that apply to other bank holding companies – including higher standards on capital, liquidity and risk management. Capital requirements should be graduated for institutions $100 billion in assets and larger to protect against losses, and act as a disincentive to growth that increases systemic risk. The imposition of systemic risk fees, which will be discussed later, also should serve as a disincentive to unbridled growth.

Financial institutions that continue to pose a systemic risk should be required to downsize to below systemic risk limits within five years, or face harsh monetary and management penalties. Any dissolution plan should include breaking up the institution and selling off pieces to other institutions, including community banks.

Research suggests that economies of scale and scope in banking are exhausted at much smaller sizes, but size does yield monopoly (market) power, 'synergies of conflict of interest' and an implicit subsidy provided by the taxpayer guaranteeing the bank against default and insolvency. [9] These abuses must end for a vibrant, competitive financial services marketplace to emerge from this crisis.

[7] March 20, 2009

[8] "Financial Reform; A Framework for Financial Stability, January 15, 2009, p. 8.

[9] Buiter, Too Big To Fail Is Too Big.

Impose Systemic Risk Premiums

Large complex financial institutions created the most severe economic crisis in the United States since the Great Depression through poor underwriting practices and a system of financial interdependence that no one even in these companies understood. Since last October, Congress has invested $700 billion in the Troubled Asset Relief Program and $700 billion in stimulus to rescue the economy, and the Federal Reserve has also dedicated hundreds of billion dollars to aide the failing economy. Out of these funds, the Federal government has dedicated more than $150 billion in taxpayer and FDIC funds to shore up the nine largest banks and more than $70 billion in assistance and guarantees to AIG. Although some of these institutions have repaid the assistance, the current financial crisis illustrates the enormous risk that large complex financial institutions pose to taxpayers and the FDIC. As a result, ICBA urges Congress to impose two types of systemic risk fees against large complex financial institutions to compensate the taxpayers and the FDIC fund for this risk exposure.

Holding Company Premiums. First, Congress should impose a systemic risk premium on all Tier I financial holding companies, broadly defined to include all large complex financial firms that have the potential of posing a systemic risk. Part of this first premium would pay for improved regulation of systemic risk. Additionally, part should be made available to the FDIC to fund the administrative costs of systemic resolutions and other costs associated with an orderly unwinding of the affairs of a failed institution.

Bank Premiums. Second, Congress should require all FDIC-insured affiliates of large complex financial firms to pay a systemic risk premium to the FDIC in addition to their regular FDIC premiums to compensate the FDIC for the increased risk they pose. Because their depositors and creditors receive superior coverage to the coverage afforded depositors and creditors of community banks, the largest financial institutions should pay an additional premium. The FDIC's Deposit Insurance Fund is ultimately responsible for insuring the deposits in those institutions. Enhancing resources available to the FDIC through a systemic-risk premium would reduce the risk that taxpayers would be called on to resolve a systemic risk depository institution.

The Bank Accountability and Risk Assessment Act of 2009, H.R. 2897, introduced by Financial Institutions Subcommittee Chairman Luis Gutierrez, would impose just such an annual systemic risk premium on all banks and thrifts that are part of systemically significant holding companies.

H.R. 2897 addresses other deposit insurance issues, which should be part of regulatory restructuring legislation. In addition to a systemic risk premium, the legislation would create a system for setting rates for all FDIC insured institutions that is more sensitive to risk than the current system. First, the legislation requires the FDIC to examine risks throughout a bank's holding company, when the FDIC establishes rates for a bank. Recent history has demonstrated that the risk to the FDIC and taxpayers cannot be determined solely by looking at a depository institution in isolation. Second, the bill requires the FDIC to consider the amount of assets and liabilities, not just the categories and concentrations of assets and liabilities.

Finally, H.R. 2897 would create an assessment base that is more closely linked to the risks in insured institutions and would create greater parity between large and small banks. The bill would broaden the assessment base used by the FDIC to determine a bank's premium by including total assets minus tangible equity for the assessment base, rather than domestic deposits. A broader assessment base would result in a fairer assessment system with the larger banks paying a share of the assessments that is proportional to their size rather than their share of total deposits.

Under the current system that assesses only domestic deposits, banks with less than $10 billion in assets pay approximately 30% of total FDIC premiums although they hold approximately 20% of total bank assets. Furthermore, 85-95 percent of the funding for these community banks comes from domestic deposits, while for banks with $10 billion or more in assets, the figure is approximately 52 percent. Thus, while community banks pay assessments on nearly their entire balance sheets, large banks pay on only half. Under H.R. 2897, banks with less than $10 billion in assets would pay about 20% of FDIC premiums, which is in line with their share of bank assets.

Moreover, the proposed base is more closely linked to risks. The amount of assets that a bank holds is a more accurate gauge of an institution's risk to the Deposit Insurance Fund (DIF) than the amount of a bank's deposits. Bad assets, not deposits, cause bank failures, and all forms of liabilities, not just deposits, fund a bank's assets. Most of the $18 billion in actual losses that the DIF incurred in 2008 came from the resolution of IndyMac Bank F.S.B., a bank with $32 billion in assets including many subprime loans and mortgage-backed securities but only $19 billion in deposits.

The proposed assessment base of assets minus tangible equity was used by the FDIC for the special assessment adopted this May. The bill would establish assets (minus tangible equity) as the assessment base for all regular and special FDIC assessments. The change would reduce the assessments of 98% of the banks with less than $10 billion in assets, keeping millions of dollars in community banks, which continue to lend to small businesses and consumer throughout America.

Improve Financial Markets

A risk-retention requirement for mortgage-backed securities could be a useful tool in regulating risk associated with the securitization process, if coupled with an exemption from the retention requirement for mortgages subject to comprehensive standard underwriting requirements, such as loans sold to the housing government sponsored enterprises or guaranteed by the Federal Housing Administration.

ICBA endorses stronger regulation of over-the-counter derivatives because of the central role credit default swaps played in the current financial meltdown.

ICBA also supports further hedge fund regulation including requiring hedge funds to (1) register with the Securities and Exchange Commission and (2) disclose appropriate information on an ongoing basis to allow supervisors to assess the systemic risk they pose individually or collectively.

Enhance Supervision of Systemically Important Payment, Clearing and Settlement Systems

ICBA supports the Administration's proposal to provide the Federal Reserve with new authority to identify and regulate systemically important payment, clearing and settlement systems. This expanded authority would allow the Federal Reserve, in conjunction with a system's primary federal regulator, to collect applicable information and to subject covered systems to regular, consistent, and rigorous on-site safety and soundness examinations to enforce compliance with applicable risk management standards.

The recent financial crisis highlighted the ineffectiveness of the structure of systems critical to the clearance and settlement of financial transactions and confidence in our financial markets. The Federal Reserve has a wealth of relevant expertise and resources that should be extended to all systems deemed systemically important. These systems should also have access to Reserve bank accounts, financial services, and the discount window for emergencies.

Protecting Consumers

Community bankers put their customers first. It's just the way we do business. ICBA strongly agrees that consumers must have clear information that they need to make informed, responsible financial decisions and must be protected from abusive, unfair or deceptive practices.

Community bankers believe that the best way to protect consumers is to end the too-big-to-fail concentration risks that cost the consumer over $7 trillion in economic worth. No disclosure or product approval system could offset the damage done by a few behemoth financial entities that brought our economy to its knees.

Unregulated individuals and companies perpetrated serious abuses on millions of American consumers. Therefore, new legislation should focus on otherwise unregulated people and institutions, and avoid adding extra burdens to community bankers who treat their customers fairly and honestly and did not engage in the behavior that fed the financial crisis. In addition, we strongly oppose proposals that would strip rule writing and supervision for community banks from agencies that also must take safety and soundness into account.

We appreciate that Chairman Frank's legislation establishing the Consumer Financial Protection Agency (CFPA), H.R. 3126, does not transfer enforcement authority over the Community Reinvestment Act (CRA) to the new agency. This is a common-sense step that allows current prudential regulators to maintain their authority over this law. CRA is intended to ensure that banks are providing services to all segments of the community. Similarly, other fair lending statutes, such as the Equal Credit Opportunity Act (ECOA) and Home Mortgage Disclosure Act, should also remain with the current financial regulatory agencies that will be conducting safety and soundness examinations. Of course, fair lending is good lending and good business. But regulators must consider safety and soundness considerations when they impose specific requirements to achieve these goals.

For community banks, safety and soundness and consumer protection are not mutually exclusive functions. Not only must these elements co-exist and be balanced in order maintain effective financial services regulation and enforcement, but also because the community banking model rests on the unique long-term relationships community bankers develop with their customers. Customers are attracted to do business with community banks because they are common sense, responsible lenders with local decision-making. Our common sense approach is also why community banks have not gotten into trouble through the use of exotic lending products that led other large firms into bankruptcy or partial government ownership. This relationship is symbiotic: instilling confidence in our customers that they will be treated honestly means a community banker is not going to take excessive risks, and will certainly not engage in an abusive practice to drive customers away. It also explains why community bankers never relaxed their lending standards simply to compete with the megabanks and non-bank lenders.

The proposed CFPA regrettably splits the safety and soundness and consumer protection functions, going so far as to place this new agency as the ultimate arbiter of any dispute between a prudential regulator and itself. While community banks go above and beyond to protect their customers, allowing consumer protection to trump safety and soundness is a dangerous precedent. Bank regulators have expertise in balancing safe and sound operation with the need to provide consumers information they need to make informed financial decisions and protect them from unfair and harmful practices. Furthermore, if stripped of their consumer protection personnel and authorities, existing agencies would be deprived of the ability to properly determine CAMEL ratings. Regulators today give consideration to consumer protection and compliance when evaluating a bank's Capital and Management during a safety and soundness exam, a critical task rendered impossible under this legislation.

The proposed agency will be responsible for regulating and enforcing actions against a universe of entities more diverse, complex, and numerous than any other existing agency is responsible for. Congress and taxpayers will need to determine how to pay for this agency's activities. It is particularly worrisome to community bankers that one of the recommended means of funding the CFPA is through a new series of fees levied on consumer products and individual transactions. It seems contradictory that an agency with a mission to protect consumers would fund itself by directly raising the cost of everyday consumer products.

Community bankers are particularly concerned that they and their customers could bear a considerable share of this added funding burden. Banks already pay significant fees for their regulation, and this proposal could well increase them.

This proposal highlights a long-standing challenge facing community banks, namely encouraging policymakers to distinguish between large and small financial institutions and not to assume that a one-size-fits-all approach is an appropriate way to legislate or regulate the financial sector. If the current economic crisis has proven anything, it is that there are significant disparities between the way large firms and smaller firms do business. Regulation for community banks should be proportional. Yet, in its current form, the CFPA is not required to make any distinction between large banks, non-bank financial firms, and community banks. In fact, only the proposed National Bank Supervisor – a regulator focused on the well-being of the largest banks in our country – is given a seat on the Agency's board.

In recent Congressional testimony, administration officials pointed out the disparity between the existing regulatory regimes for federally insured banks and those for non-bank financial firms.

We agree that the lack of sufficient regulatory oversight of many unregulated firms, particularly those in the mortgage industry, contributed significantly to our financial crisis. However we disagree with a response that, instead of focusing on regulatory gaps and augmenting existing systems, places community banks into an entirely new regime with only vague limits and checks on its powers.

We also disagree with the notion that community banks would be better served under a new regulator that has no definitive mandate to consider the differences between the products offered by a large, national bank and a community bank operating exclusively in a small geographic area. For example, many community banks have for years offered short-term balloon loans to members of their communities. This was not done to be predatory, but rather because that type of product made most sense for the individual needs of a select group of bank customers in a defined geographic area. Such a product would likely fall outside the agency-approved definition of a "standard" financial product, and would be subject to stricter and costlier regulation. While community banks generally offer sensible, simple products, this one example highlights how our unique understanding of the needs of our community will often not coincide with the one-size-fits-all product parameters defined by the proposed CFPA in Washington.

Community bankers need the flexibility to offer the products and services best suited to the specific needs of their customers, and a regulator able to balance this need with safety and soundness. This proposed agency, by separating these two regulatory functions and enforcing product mandates and adding new costs to consumer products, will unquestionably reduce the ability of small community banks to operate effectively in their communities.

By divorcing safety and soundness regulation from consumer protection regulation and mandating specific products, this proposal sets the stage for the broadest, most substantial increase in regulatory burden on community banks our industry has ever experienced. The CFPA as proposed will dramatically reshape the operating and regulatory environment for community banks in a way that will inevitably make it difficult for community banks to continue to efficiently serve their local economies.

Congress has an historic opportunity to greatly enhance consumer financial protection but the current proposal does not do this. It could well make financial products more expensive – or even unavailable – for community bank customers.

Assistant Treasury Secretary for Community Financial Institutions

The current economic downturn has revealed just how critical community banks are to our country's financial system and why we need to give them appropriate consideration when devising national policies and programs. Recent reports by the FDIC indicate that even when the biggest banks have stopped lending, community banks have seen an increase in their loans. Despite the fact that they are a vital part of our nation's banking system, there is no Assistant Secretary at the Department of Treasury to coordinate federal policy for smaller financial institutions.

For more than two decades, Treasury has taken the lead in crafting the Federal government's response to crises in the banking sector and formulating regulatory reforms to prevent reoccurrences of the crises. Because Treasury plays a central role in Federal banking and economic policy, it is important that community banks have a voice inside Treasury advising the Secretary on how policies will impact community banks. Two actions by the Bush Treasury Department in response to the current financial crisis highlight the need for a community bank advocate inside Treasury.

First, Treasury created a money market mutual fund insurance program overnight with almost no statutory authority. The fees charged to the mutual fund industry for the guarantee were minimal compared to the price that banks have paid for deposit insurance. Treasury's action gave a community bank competitor a significant advantage. The original plan would have given unlimited coverage to money market funds, which would have devastated community bank liquidity with runs on deposits. Although Treasury eventually limited coverage to amounts already in the funds, thanks to intervention by the FDIC and the banking industry, these events illustrate how the Treasury can overlook the community banking sector.

Second, when Fannie Mae and Freddie Mac were put in conservatorship last year, Treasury drastically misjudged the impact of the conservatorship on community bank holders of GSE preferred shares. Prior to the conservatorship, regulators had encouraged community banks to purchase GSE preferred shares as a safe investment that supported housing. Treasury believed that the conservatorship would impact less than ten community banks, when, in fact, the actions wiped out large amounts of capital at hundreds of community banks. While we appreciate the limited tax relief Congress provided community bank preferred shareholders, many community banks are still burdened by the loss of capital caused by the devaluation of their GSE preferred shares.

H.R. 2676, the Oversight for Community Financial Institutions Act of 2009, introduced by Rep. Dennis Cardoza, would create an Assistant Treasury Secretary for Community Financial Institutions. H.R. 2676 would ensure that community banks – including minority-owned institutions – are given appropriate and balanced consideration in the Treasury policy-making process. This is absolutely vital to the continued health and strength of our nation's community banks and the communities they serve. ICBA urges that H.R. 2676 be included in the regulatory reform legislation.

Note on the Current Regulatory Environment

As Congress grapples with major financial reform proposals, it is important to ensure the current regulatory environment is conducive to small business lending. Overzealous bank regulation is hurting small business lending and the economic recovery. New special assessments are being applied in a pro-cyclical manner on financial institutions when they can least afford these additional costs. The massive monetary and fiscal stimulus already put in place will not achieve its intended benefit if banks are forced to pull in their lending due to overly restrictive regulations or excessive fees. The flow of bank credit is essential to a strong economic recovery. Unfortunately pro-cyclical bank regulatory policies will jeopardize credit availability for many small businesses.

ICBA believes the bank regulatory pendulum has swung too far and is crushing many community banks' ability to lend to deserving small businesses. While community banks did not cause the current financial crisis, bank regulators are often applying crippling regulatory exams and policies across-the-board.

Community bankers nationwide continue to report to ICBA about overzealous and unduly, overreaching examiners second guessing bankers and appraisers and demanding overly aggressive write-downs and reclassifications of viable and performing commercial real estate loans and other assets. Examiners are requiring write-downs or classification of performing loans due to the value of collateral irrespective of the income or cash flow of the borrowers; placing loans on non-accrual even though the borrower is current on payments; discounting entirely the value of guarantors; criticizing long-standing practices and processes that have not been criticized before; and substituting their judgment for that of the appraiser.

Other bankers are concerned that otherwise solid loans are being downgraded simply because they are located in a state with a high mortgage foreclosure rate. This form of stereotyping is tantamount to statewide redlining that is unjustified in today's economic climate and could ultimately lead to capital problems at otherwise healthy banks.

This examination environment is exacerbating the contraction in credit for small businesses, as community bankers must avoid making good loans for fear of examiner criticism, write-downs, and the resulting loss of income and capital. While it is expected and understandable that examiners will be more thorough and careful during a credit downturn, excessively tough exams that result in potentially unnecessary loss of earnings and capital can have a dramatic and adverse impact on the ability of community banks to provide small business loans and the ability to support economic growth.

Conclusion

ICBA appreciates this opportunity to testify on financial regulatory reform and it potential impact on small business. To protect and grow our nation's small businesses and economy it is essential to get financial reform right. The highly-regulated community banking sector did not trigger the financial crisis. We must end too-big-to-fail, reduce systemic risk and focus regulation on the unregulated financial entities that caused the economic meltdown. The best financial reforms will protect small businesses from being crushed by the destabilizing effects when a giant financial institution stumbles. ICBA opposes full consolidation of the banking regulators into a monolithic, risky, single regular. Financial reforms that preserve and strengthen the viability of community banks are key to a diverse and robust credit market for small business. Thank you.

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Chairwoman Velazquez, Ranking Member Graves, and Members of the Small Business Committee, thank you very much for the opportunity to testify at today's hearing on the "Impact of Financial Regulatory Restructuring on Small Businesses" on behalf of the Credit Union National Association (CUNA). My name is Bill Hampel, and I am Senior Vice President for Research and Analysis and Chief Economist at CUNA, the nation's largest credit union advocacy organization, representing over 90% of our nation's approximately 8,000 state and federal credit unions, their State credit union leagues, and their 92 million members.

The collapse of the financial system exposed flaws in the regulation of US financial institutions, and these flaws absolutely must be addressed. However, we believe these efforts should focus on protecting consumers, preserving their financial choices—including through dual chartering—ensuring the adequate provision of financial services to consumers and small businesses, and limiting the systemic risk that is currently posed by those institutions within the financial system which present disproportionate risk and have not been subject to sufficient regulatory oversight.

Most of the current crisis was caused by the actions of relatively unregulated financial institutions, and by compensation practices at even regulated institutions that encouraged excessive risk taking. Neither of these two factors exists at credit unions. Credit unions did not in any way contribute to the current financial debacle and their current regulatory regime, coupled with their cooperative structure, militates against credit unions ever contributing to a financial crisis. As Congress moves forward, it is also important that Congress not "throw the baby out with the bathwater." Regulatory restructuring should not exclusively mean more regulation.

There needs be recognition that in certain areas—credit unions come to mind—the regulation and enforcement was sound and the regulated entities performed well, and an appreciation that smarter regulation is appropriate.

Credit unions have several concerns in the regulatory restructuring debate, including the preservation of the independent credit union regulator, the development of the Consumer Financial Protection Agency and the restoration of credit unions' ability to serve their business-owning members.

Independent Credit Union Regulator

First and foremost, it is critical that Congress retain an independent credit union regulator -- to further the interests of credit union member/owners, as distinct from bank customers. Credit unions' unique mission, governance structure, and ownership structure necessitate an independent federal regulator in order to ensure that the credit union model is not eroded as a result of the misapplication of bank regulations to credit union operations. Cooperatives really are different. They are subject to a completely different set of incentives that tend to create a much more member-friendly, risk-averse operation than a for-profit institution. Unlike banks, credit unions are not-for-profit institutions that exist to serve their member-owners rather than to profit from them. Also unlike banks, the members of the credit union own their institutions, which are subject to a democratic, one-member-one-vote system irrespective of members' account balances or any other factor.

The importance of an independent credit union regulator extends beyond philosophical and structural issues and is well illustrated by the historical posture that federal banking regulators have taken towards credit unions. A previous head of the Federal Deposit Insurance Corporation (FDIC) publicly called for taxation of credit unions, and the Office of Thrift Supervision, which has sometimes been short on institutions to regulate, has encouraged credit unions to convert to thrift charters. This should come as no surprise because those agencies' bank stakeholders view credit unions as their competition and spend a great deal of time, money, and effort lobbying against credit union interests, suing the National Credit Union Administration (NCUA), and using any other available means to try to put credit unions out of business.

Although there may be a strong logic for some consolidation among banking regulators, where competition among regulators for institutions to regulate can lead to lax regulation and supervision, that condition does not exist for credit unions. There is only one federal regulator for credit unions, and the general health of the credit union system in the current financial crisis proves that the current system works quite well. We encourage Congress to retain the National Credit Union Administration as the independent credit union regulator, and we are heartened that President Obama and House Financial Services Committee Chairman Frank have expressed support for NCUA.

Consumer Financial Protection Agency

Credit unions are also carefully following the development of legislation to create a Consumer Financial Protection Agency (CFPA). Consumers of financial products, especially consumers of products and services provided by currently unregulated entities, need greater protections, and CUNA agrees that a CFPA could be an effective way to achieve that protection, provided the agency does not impose duplicative or unnecessary regulatory burdens on credit unions.

In order for a CFPA to work, consumer protection regulation must be consolidated and streamlined; it should not add to the regulatory burden of those that have been regulated and performed well, such as credit unions.

Examination and Enforcement

Credit unions are extremely concerned that the legislation will result in an additional set of annual examinations they will have to pay for and that such examinations will be conducted by examiners who are not familiar with credit unions and do not understand or appreciate what makes them unique. Most credit unions are extremely small institutions relative to the largest banks and non-bank entities. Some have just a handful of employees. A separate consumer protection examiner will distract credit unions from their mission and divert resources away from serving their members.

We strongly feel the CFPA should have full authority to write the rules for consumer protection, but for regulated entities such as credit unions, the examination, supervision and enforcement of these regulations should be retained by the prudential regulator, with all consumer protection exam reports and actions shared with the CFPA. The currently unregulated entities should certainly be examined by the CFPA. We would also support giving the CFPA back-up examination powers over regulated depository institutions, such as when material complaints repeatedly arise about the implementation of a particular regulation. CPFA examiners could also examine regulated depository institutions on a random, backup basis.

Regulatory Consolidation and Modernization

The statutory mission of the CFPA must require that the agency streamline and modernize consumer protection regulation so as to minimize unnecessary regulatory burden. Duplicative and overlapping rules are draining the resources of many credit unions and must be eliminated.

If a single agency were responsible for writing the regulations for all consumer regulation, compliance could be streamlined, consumer understanding increased, and duplicative requirements eliminated. For instance, the reconciliation of the *Truth in Lending Act* and the *Real Estate Settlement Procedures Act* mortgage lending disclosures is strongly supported by credit unions.

As Harvard University Professor Elizabeth Warren testified, "a single regulatory agency watching out for families and individuals can reduce the overall regulatory burden."[1] Assistant Treasury Secretary Michael Barr has made similar statements: "The CFPA is not a new layer of regulation; it will consolidate existing regulators and authorities. This will bring efficiencies for industry."[2] We urge Congress to ensure that this vision becomes a reality.

Credit unions are the most highly regulated of all financial institutions. In addition to the consumer protection and other laws with which banks must also comply, credit unions have an extensive list of unique operating restrictions including defined fields of membership, limits on capital acquisition, statutory capital requirements, and severe limits on member business lending. In addition, Federal credit unions are subject to a loan interest rate ceiling, limitations on loan maturities, and stringent limitations on their investment options.

It is very important to credit unions that any regulations adopted by the CFPA have reasonable compliance effective dates and be amended in an orderly fashion so that regulations are not

[1] Testimony of Elizabeth Warren before the House Financial Services Committee. June 24, 2009. 5.
[2] Testimony of Michael Barr before the House Energy and Commerce Committee. July 8, 2009. 9.

continually being revised. The Federal Reserve Board's April- October schedule for Truth-in-Lending changes provides one model for how changes could be considered and adopted. Credit unions are understandably concerned that an agency with the sole mandate of developing and amending consumer law regulations will continually modify them to respond to new issues and complaints. A new CFPA must have procedures to assure that credit unions are not overwhelmed with regulatory revisions.

Preemption

Credit unions strongly feel that for the mission of the CFPA to be fulfilled, Congress must take an understandably difficult step of preempting state consumer protection laws.

In order to achieve the regulatory simplicity that is a key objective for consumers and financial institutions alike under the new agency, there needs to be one rule of the road on consumer protection issues. If Congress creates a CFPA and its rules merely become the floor in terms of consumer protection, many state laws will remain or be passed, and the size and complexity of consumer disclosures will be unmanageable for institutions and incomprehensible for consumers. In short, the consumer will not see the simplification benefits of this agency if there is not preemption.

We are well aware of the sensitivities of proposing federal preemption of state laws that address the same subjects as the authority given to the CFPA to cover financial services and products on credit, savings, payment products, and related services. We think state concerns could be addressed by ensuring states retain authority over state safety and soundness issues and by giving states "a seat at the table," so that they have direct and continued input into the consumer protection regulations developed by the new federal agency. This could be achieved by designating one of the CFPA Board seats to be filled by a representative of a state consumer protection agency or a state Attorney General's office or any other way the Committee finds appropriate, such as giving a state representative a leadership role in any CFPA advisory group approved by statute. As states identify consumer protection concerns that they might otherwise have sought state legislation or regulation to address, they can come to the CFPA and be assured they will have someone designated to consider their views.

We urge Congress to preempt state consumer protection law when establishing the CFPA, and we are confident that by charging a single federal agency with the responsibility to regulate consumer protection law, as well as with rigorous Congressional oversight, more thorough consumer protection regulation will be achieved. If the CFPA is sufficiently empowered to be a credible regulator ensuring nationwide consumer protection, why should any additional state rules be necessary? Conversely, if the proposed CFPA is not expected to be adequate to the task, why establish such a new agency in the first place?

Restoration of Credit Unions' Ability to Serve Business Owning Members

As Congress considers regulatory restructuring legislation, we strongly urge the enactment of legislation that will restore credit unions' ability to serve the lending needs of their business-owning members.

Madame Chairwoman, the issue of credit union member business lending has been politicized by interest groups that benefit from artificial restrictions on credit union business lending authority, i.e., lenders who want the field all to themselves.

There is no economic or safety and soundness rationale to restricting credit union member business lending to 12.25% of a credit union's total assets. Before this restriction was enacted in 1998, credit unions faced no statutory restriction on business lending; and a report released by the U.S. Treasury Department after the restrictions were enacted found that business lending credit unions were more regulated than other financial institutions, and that delinquencies and charge-offs for credit union business loans were "much lower" than that for either banks or thrift institutions. That is still the case today. In the first half of 2009, the annualized net charge-off rate on business loans at credit unions was 0.36%. It was nearly six times greater, 2.13%, at banks. Simply put, the only reason there is a restriction on credit union business lending is because the banking lobby was able to leverage the restriction when credit unions sought legislation to permit them to continue serving their members.

The credit union business lending cap is overly restrictive and undermines public policy to support America's small businesses. It severely restricts the ability of credit unions to provide loans to small businesses at a time when small businesses are finding it increasingly difficult to obtain credit from other types of financial institutions, especially larger banks, and it also discourages credit unions who would like to enter the business lending market. The cap effectively limits entry into the business lending arena on the part of small- and medium-sized credit unions—the vast majority of all credit unions—because the startup costs and requirements, including the need to hire and retain staff with business lending experience, exceed the ability of many credit unions with small portfolios to cover these costs.

We are under no illusion that credit unions can be the complete solution to the credit crunch that small businesses face. After all, nationally, credit union business lending represents just over one percent (1.06%) of the depository institution business lending market; and credit unions have about $33 billion in outstanding business loans, compared to $3.1 trillion for banking institutions. But we do think credit unions can – and should – be part of the solution.

Eliminating or expanding the limit on credit union member business lending would allow more credit unions to generate the portfolios needed to support compliance with NCUA's regulatory requirements, and would expand business lending access to many credit union members, thus helping local communities and the economy.

Indeed, there is, a significant economic reason to permit credit unions to lend without statutory restriction: America's small businesses need the access to credit. As the financial crisis has worsened, it has become more difficult for small businesses to get loans from banks, or maintain the lines of credit they have had with their bank for many years.

While we support raising member business loan limits, which will benefit small businesses as well as the economy, we also appreciate the need for strong regulatory oversight of member business lending. Indeed, increasing the limits on member business lending will not diminish credit unions' regulators authority to supervise such loans and the credit unions that provide them. We want to work with the regulator to facilitate underwriting practices and standards that will ensure safety and soundness remains a priority in member business lending.

A growing list of small business and public policy groups agree that now is the time to eliminate the statutory credit union business lending cap, including the Americans for Tax Reform, the Competitive Enterprise Institute, the Ford Motor Minority Dealer Association, the League of United Latin American Citizens, the Manufactured Housing Institute, the National Association of Mortgage Brokers, the National Cooperative Business Association, the National Cooperative

Grocers Association, the National Farmers Union, the National Small Business Association, the NCB Capital Impact, the National Association of Professional Insurance Agents, and the National Association of the Self Employed.

Representatives Paul Kanjorski (D-PA) and Ed Royce (R-CA) have introduced H.R. 3380, the Promoting Lending to America's Small Businesses Act, which would increase the credit union member business lending cap to 25% of total assets and revise the statutory floor on what constitutes an MBL from the current \$50,000 to a more realistic level of \$250,000. We estimate that credit unions could—safely and soundly—provide as much as \$10 billion in new loans for small businesses within the first year of H.R. 3380's enactment. This is economic stimulus that would not cost the taxpayers a dime, and would not increase the size of government.

Madame Chairwoman, thank you very much for convening this hearing and inviting me to testify. I look forward to answering the Committee's questions.

NAFCU

Testimony of

Dawn Donovan
Chief Executive Officer
Price Chopper Employees Federal Credit Union

on Behalf of

The National Association of Federal Credit Unions

"The Impact of Financial Regulatory Restructuring on Small Businesses"

Before the

House Small Business Committee

United States House of Representatives

September 23, 2009

Introduction

Good afternoon, Chair Velazquez, Ranking Member Graves and Members of the Committee. My name is Dawn Donovan and I am testifying today on behalf of the National Association of Federal Credit Unions (NAFCU). I serve as the President and CEO of Price Chopper Employees Federal Credit Union, headquartered in Schenectady, New York. I have been with Price Chopper Employees FCU for the last 15 years. I currently serve on the NAFCU Regulatory Committee and am a past member of NAFCU's Legislative Committee. PCE FCU is a single sponsor credit union serving employees of Price Chopper Supermarkets in the Northeast. PCE FCU has approximately 4,500 members and just over $19 million in assets.

NAFCU is the only national organization exclusively representing the interests of the nation's federally-chartered credit unions. NAFCU–member credit unions collectively account for approximately 65.4 percent of the assets of all federally chartered credit unions. NAFCU and the entire credit union community appreciate the opportunity to participate in this discussion regarding how financial regulatory restructuring will impact America's credit unions.

Historically, credit unions have served a unique function in the delivery of necessary financial services to Americans. Established by an act of Congress in 1934, the federal credit union system was created, and has been recognized, as a way to promote thrift and to make financial services available to all Americans, many of whom would otherwise have limited access to financial services. Congress established credit unions as an alternative to banks and to meet a precise public need—a niche credit unions fill today for nearly 92 million Americans. Every credit union is a cooperative institution organized "for the purpose of promoting thrift among its members and creating a source of credit for provident or productive purposes." (12 USC 1752(1)). While over 75 years have passed since the *Federal Credit Union Act* (FCUA) was signed into law, two fundamental principles regarding the operation of credit unions remain every bit as important today as in 1934:

- credit unions remain totally committed to providing their members with efficient, low-cost, personal financial service; and,
- credit unions continue to emphasize traditional cooperative values such as democracy and volunteerism.

Credit unions are not banks. The nation's approximately 7,800 federally insured credit unions serve a different purpose and have a fundamentally different structure than banks. Credit unions exist solely for the purpose of providing financial services to their members, while banks aim to make a profit for a limited number of shareholders. As owners of cooperative financial institutions united by a common bond, all credit union members have an equal say in the operation of their credit union—"one member, one vote"—regardless of the dollar amount they have on account. These singular rights extend all the way from making basic operating decisions to electing the board of directors—something unheard of among for-profit, stock-owned banks. Unlike their counterparts at banks and thrifts, federal credit union directors generally serve without remuneration—a fact epitomizing the true "volunteer spirit" permeating the credit union community.

Credit unions have grown steadily in membership and assets, but in relative terms, they make up a small portion of the financial services marketplace. Federally-insured credit unions have approximately $813.4 billion in assets as of year-end 2008. By contrast, Federal Deposit Insurance Corporation (FDIC) insured institutions held $13.9 trillion in assets and last year grew by an amount exceeding the total assets of credit unions. The average size of a federal credit union is $92.5 million, compared with $1.673 billion for banks. Over 3,200 credit unions have less than $10 million in assets. The credit union share of total household financial assets is also relatively small, at just 1.4 percent as of December 2008.

Size has no bearing on a credit union's structure or adherence to the credit union philosophy of service to members and the community. While credit unions may have grown, their relative size is still small compared with banks. Even the world's largest credit union, with $36.4 billion in assets, is dwarfed by the nation's biggest banks with trillions of dollars in assets.

America's credit unions have always remained true to their original mission of "promoting thrift" and providing "a source of credit for provident or productive purposes." In fact, Congress acknowledged this point when it adopted the *Credit Union Membership Access Act* (CUMAA – P.L. 105-219) a decade ago. In the "findings" section of that law, Congress declared that "[t]he American credit union movement began as a cooperative effort to serve the productive and provident credit needs of individuals of modest means ... [and it] continue[s] to fulfill this public purpose."

Credit unions continue to play a very important role in the lives of millions of Americans from all walks of life. As consolidation of the commercial banking sector has progressed, with the resulting depersonalization in the delivery of financial services by banks, the emphasis in consumers' minds has begun to shift not only to services provided, but also—more importantly—to quality and cost. Credit unions are second-to-none in providing their members with quality personal financial services at the lowest possible cost.

While the lending practices of many other financial institutions led to the nation's subprime mortgage debacle, data collected under the *Home Mortgage Disclosure Act* (HMDA) illustrates the value of credit unions to their communities. The difference between credit unions and banks is highlighted when one examines the 2007 *HMDA* data for loans to minority applicants with household incomes under $40,000. According to the 2007 *HMDA* data, banks have a significantly higher percentage of mortgage purchase loans (20.8 percent), charging at least 3 percent higher than the comparable Treasury yield for minority applicants with household income under $40,000. Credit unions, on the other hand, had only 4.4 percent of their loans in that category.

Credit Unions in the Current Economic Environment

While credit unions have fared better than most financial institutions in these turbulent economic times, many have been impacted, through no fault of their own, by the current economic environment. In particular, the corporate credit union system has felt the biggest impact and NCUA placed the two largest corporate credit unions, U.S. Central Federal Credit Union and Western Corporate Federal Credit Union, into conservatorship earlier this year. The passage and enactment of S. 896, *The Helping Families Save Their Homes Act of 2009,* and the temporary corporate credit union stabilization fund it created, provided important relief to natural-person credit unions in these challenging times.

It is also widely recognized by leaders on Capitol Hill and in the Administration that credit unions did not cause the current economic downturn. However, we believe we can be an important part of the solution. Credit unions have fared well in the current environment and, as a result, many have capital available. Surveys of NAFCU-member credit unions have shown that many are seeing increased demand for mortgage loans and auto loans as other lenders leave the market. A number of small businesses who have lost important lines of credit from other lenders are turning to credit unions for the capital that they need. However, more can still be done.

Our nation's small businesses represent 99.7 percent of all employer firms, employ half of all private sector employees, pay more than 45 percent of total U.S. private payroll, and have generated 60 to 80 percent of net new jobs annually over the last decade. Therefore, NAFCU believes the strength of the economy is strongly influenced by the health and well-being of America's small businesses. Many small business owners are members of credit unions around the country and rely on our services to help make their small businesses successful. Our nation's credit unions stand ready to help in this time of crisis and, unlike other institutions, have the assets to do so. Unfortunately, an antiquated and arbitrary member business lending cap prevents credit unions from doing more for America's small business community.

The *Credit Union Membership Access Act* (CUMAA) established an arbitrary cap on credit union member business lending of 12.25% of assets in 1998. CUMAA also directed the Treasury Department to study the need for such a cap. In 2001, the Treasury Department released its study, entitled "Credit Union Member Business Lending," in which it concluded that "credit unions' business lending currently has no effect on the viability and profitability of other insured depository institutions." The same study also found that over 50 percent of credit union loans were made to businesses with assets under $100,000, and 45 percent of credit union business loans go to individuals with household incomes of less than $50,000.

The current economic crisis has demonstrated the need to have capital available to help our nation's small businesses, especially in troubling times. Many credit unions have the capital other lenders cannot provide in this current environment, but are hamstrung by this arbitrary limitation. It is with this in mind that NAFCU strongly supports the passage of H.R. 3380, the *Promoting Lending to America's Small Business Act of 2009*. Introduced by Representatives Kanjorksi and Royce, this important piece of legislation would raise the member business lending cap to 25% while also allowing credit unions to supply much needed capital to underserved areas, which have been among the hardest hit during the current economic downturn.

NAFCU also strongly supports the reintroduction of the *Credit Union Small Business Lending Act*, which was first introduced by Chair Velazquez in the 110th Congress. This bill would have exempted credit union participation in Small Business Administration (SBA) lending programs from the MBL limits currently in place. These particular programs are invaluable tools, helping many Americans to successfully start and run their own businesses.

By exempting credit union participation in these programs, small businesses throughout the nation will have greater access to capital at a time when it is needed most. We also support a continuation of the 90% guarantee on SBA loans. We view changes to allow credit unions to do more to help our nation's small businesses as an important step of reform to help our nation recover from the current economic downturn.

Financial Regulatory Reform and Credit Unions

Credit unions remain some of the most highly regulated of all financial institutions, facing restrictions on who they can serve and their ability to raise capital. There are many consumer protections already built into the Federal Credit Union Act, such as the only federal usury ceiling on financial institutions and a prohibition on pre-payment penalties others often use to trap consumers into products. However, as the current Congress and Administration mull an entire overhaul of the nation's regulatory regime for financial institutions, NAFCU feels it is important to point out the current regulatory scheme for credit unions has served the 92 million American credit union members well.

As not-for-profit member-owned cooperatives, credit unions are unique institutions in the financial services arena and make up only a small piece of the overall financial services pie. We believe the NCUA should remain the sole, independent regulator of credit unions, and are pleased to see that the Administration's proposal would maintain this independence as well as the federal credit union charter. The fact that credit unions were not the cause of the current crisis is evidence that the current regulatory framework for credit unions is working.

NAFCU also believes the Administration's proposal on regulatory reform is well-intentioned in its effort to protect consumers from the predatory practices that led to the current crisis. We feel there have been many unregulated bad actors pushing bad products onto unsuspecting consumers and we applaud efforts to address this abuse.

It is with this in mind that we can support the creation of a Consumer Financial Protection Agency (CFPA) which would have authority over non-regulated institutions that operate in the financial services marketplace. However, NAFCU does not believe such an agency should be given authority over regulated, federally-insured depository institutions, and would oppose extending this authority to federally-insured credit unions. As the only not-for-profit institutions that would be subject to the CFPA, credit unions would stand to get lost in the enormity of the proposed agency, and credit union members, as compared to stockholders and owners of other firms, will be the ones that ultimately bear the cost of this new regulator. It is with this in mind that we could also support a CFPA that did not have not-for-profits under its purview.

Giving the CFPA the authority to regulate, examine and supervise credit unions already regulated by the NCUA would add an additional regulatory burden and cost to credit unions. Additionally, it could lead to situations where institutions regulated by one agency for safety and soundness find their guidance in conflict with the regulator for consumer issues.

Such a conflict and burden will surely increase compliance costs to credit unions, leading to diminished services to their members. Credit unions already fund the budget for NCUA. The

Administration's proposal for the CFPA would also be funded by industry, meaning an additional cost burden to credit unions and their 92 million members. As not-for-profits, credit unions cannot raise money from stock sales or capital markets. This money comes from their members' deposits, meaning credit union members would disproportionately feel the cost burden of a new agency.

NAFCU is also concerned the proposal would grant the CFPA the authority to regulate mortgage, title and credit insurance. Any financial activity the agency determines is not part of the "business of insurance" would fall under its jurisdiction, including mortgage, title and credit insurance. We note that insurance is *not* an extension of credit. Instead, it protects against risk of loss. The fact that some insurance protection covers risks surrounding a credit transaction does not alter the essence of the insurance product. Given this distinction, we believe mortgage, title and credit insurance should not be included within the CFPA mandate.

However, NAFCU also recognizes that more should be done to help consumers and look out for their interests. We would propose, rather than extending the CFPA to federally-insured depository institutions such as federal credit unions, each functional regulator (such as the NCUA) for these institutions create a new or strengthened office on consumer affairs. We are pleased to see the NCUA recently announced its intention to create such an office.

We envision such an office could report directly to the Presidential appointees at the regulator and be responsible for making sure the regulator is looking out for consumer concerns in writing rules, supervising and examining institutions compliance, and administratively enforcing violations. Consumer protection offices at the functional regulators will ensure those regulating consumer issues at financial institutions have knowledge of the institutions they are examining and knowledge and guidance on consumer protection. This is particularly important to credit unions, as they are regulated and structured differently than others in financial services, and we believe it is important for the regulator examining credit unions to understand their unique nature. We believe such an approach would strengthen consumer protection while not adding unnecessary regulatory burdens on our nation's financial institutions.

There has also been a recent proposal by Representative Walt Minnick to create a "Consumer Financial Protection and Financial Institutions Examination Council," modeled on the Federal Financial Institutions Examination Council to promote consumer protection (instead of a new CFPA). This proposal would also bolster consumer protection responsibilities of the functional regulators, along the lines of what we have outlined above. We believe that this in an idea that deserves further study and consideration.

Regulatory Reform: Executive Compensation

As not-for-profit, member-owned cooperatives the success of the credit union industry can be attributed not only to its structure and nature, but to the fact credit unions, unlike for-profit entities, are singularly focused on service to their members and do not chase stock returns. In fact, credit unions do not issue stock. Furthermore, they are governed by a volunteer board of credit union member directors, generally serving without remuneration, who ultimately decide the compensation for key employees of the credit union. It is, therefore, critical for non-profits to be treated differently than for-profit entities. Quite frankly, those running for-profit entities, including community banks, have a profit motive that can open the door for abuse, even at smaller institutions. Those running not-for-profit cooperatives have a different motivation, which lessens the incentive for abuse.

It is with this in mind that NAFCU opposes the inclusion of credit unions as covered institutions under the recent House-passed executive compensation measure – H.R. 3269. Having the NCUA prescribe joint regulations in conjunction with other regulators who supervise for-profit, stock-issuing entities does not make sense.

Simply stated, credit unions are not guided by the profit motive or stock price manipulation which created the need for this legislation. Therefore, while NAFCU supports the underlying reform intended by this legislation, we believe credit unions should be exempt from these mandates. Credit unions were founded on the precept of "people helping people" and providing credit and thrift for provident purposes, rather than to chase large profits and astronomical bonuses.

Regulatory Reform: Community Reinvestment Act

Finally, some have advocated expanding the Community Reinvestment Act (CRA) as part of the overall regulatory reform effort. NAFCU opposes extending CRA to federal credit unions. Federal credit unions are already examples of CRA in action. CRA was adopted as a punitive measure to punish specific bad actors – namely banks and thrifts – for engaging in discriminatory practices such as redlining and disinvestment. While some say CRA was to blame for the subprime crisis, we do not believe this to be the case. Credit unions were not included under CRA because there has never been any evidence suggesting credit unions have engaged in these illegal and abhorrent activities.

Credit unions are inherently invested in their communities, operating with a not-for-profit cooperative structure and a common bond membership, unlike other depository institutions. Credit unions embrace the unique relationship they have with their community and play an important role in providing important financial services to underserved individuals.

By law, credit unions can only take deposits and make loans to their membership. As many have wisely noted, if all financial institutions acted like credit unions, there would be no need for CRA. We firmly believe that placing CRA requirements on credit unions would create new regulatory burdens without public benefit—a solution in search of a problem.

Many credit union members come from the low-income and minority populations of our society. Although banks and thrifts are subject to CRA, HMDA data clearly indicates credit unions are outperforming banks and thrifts in terms of loan and price spreads as well as service to these particular segments of the population.

According to the 2007 HMDA data, credit unions outperformed both banks and thrifts in terms of lending to low income and minority populations, providing smaller mortgage loans, and having a higher percentage of these mortgage loans go to low- and moderate-income communities. We do not support extending CRA to credit unions and do not believe new CRA burdens should be part of any regulatory reform.

Conclusion

In conclusion, the current economic crisis is having an impact on America's credit unions, but they continue to provide excellent service to their members. NAFCU recognizes that problems and bad actors exist in the financial system and that reforms are needed. However, we believe it is important to point out that credit unions were not the cause of the current crisis and there is evidence that the regulation of credit unions in protecting their 92 million members has held up well. Credit unions stand ready to help our nation and our nation's small businesses recover from the current economic downturn and it is important that regulatory reform aid, and not hamper, those efforts.

Finally, while there are positive aspects to consumer protection in regulatory reform, we believe federal credit unions continue to warrant an independent regulator handling both safety and soundness and consumer protection matters. Moving aspects of credit union regulation away from the NCUA, to a new regulator like the CFPA, would likely increase costs and compliance burdens on credit unions. As not-for-profits, these costs are ultimately borne by credit union members. Regulatory reform should not mean new regulatory costs and burdens.

I thank you for the opportunity to appear before you today on behalf of NAFCU and would welcome any questions that you may have.

SIFMA
Securities Industry and Financial Markets Association

Written Testimony

of

E. John Moloney

President and CEO

Moloney Securities Company, Inc.

Chairman

Small Firms Committee

Securities Industry and Financial Markets Association

Before the House Committee on Small Business

September 23, 2009

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Good afternoon, Chairwoman Velázquez, Ranking Member Graves and Members of the Committee. My name is John Moloney and I am President and Chief Executive Officer with Moloney Securities Company, Inc., located in Manchester, MO and Chairman of the Small Firms Committee[1] of the Securities Industry and Financial Markets Association[2] Thank you for the opportunity to testify before you on behalf of SIFMA on how changes to the financial regulatory system could affect small broker-dealers.

SIFMA and its small firm members applaud your efforts and the on-going leadership of the Small Business Committee to be the advocate of small businesses in Congress. Small businesses are the backbone of the U.S. economy and small broker-dealers are instrumental in serving individual investors and entrepreneurs in Main Street America. Small broker dealers, which comprise the overwhelming majority of SIFMA's membership, service niche markets and local communities, and help in job creation.

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[1] In addition to serving as Chairman of the SIFMA Small Firms Committee, Mr. Moloney is a current member of the FINRA Membership Committee, past member of the FINRA Small Firms Advisory Board and FINRA Advisory Council, and past Chairman of the District Committee for FINRA District #4. He is also a past member of the Securities Industry/Regulatory Council on Continuing Education.

[2] SIFMA brings together the shared interests of more than 600 securities firms, banks, and asset managers. SIFMA's mission is to promote policies and practices that work to expand and perfect markets, foster the development of new products and services, and create efficiencies for member firms, while preserving and enhancing the public's trust and confidence in the markets and the industry. SIFMA works to represent its members' interests locally and globally. SIFMA's members account for about 90% of the nation's municipal bond underwriting and trading activity by volume, which represented an estimated $5 trillion of municipal bonds in 2008. It has offices in New York, Washington, D.C., and London. Its associated firm, the Asia Securities Industry and Financial Markets Association, is based in Hong Kong. More information may be found at our website: http://www.sifma.org.

As of August 2009, FINRA, the Financial Industry Regulatory Authority, reported that there are 4,797 registered broker-dealers.[3] Of these, it is estimated that some 4,600 are smaller broker-dealers defined by FINRA as having 150 registered persons, or fewer. That is the constituency I represent. My firm, Moloney Securities, is a general securities broker-dealer with 110 registered brokers and 20 support staff. We have three Offices of Supervisory Jurisdiction (OSJ) located in St. Louis, Kansas City and Denver, plus nineteen additional registered branches located in fourteen states. We are dually registered as a broker-dealer and as an investment adviser. Moloney Securities does not custody customer securities or cash. We clear customer transactions through two clearing firms. Our firm, like the overwhelming majority of broker-dealers, was not a TARP recipient.

As a threshold matter I wish to point out that the majority of the financial services reform proposals before Congress do not impact smaller firms like mine. Small firms are concerned that the changes contemplated for large, global, financial services firms could cause disparate effects on small firm operations. That being said, and because investor confidence in the markets is important to all firms regardless of size, I wish to echo the comments of SIFMA's President and CEO, Tim Ryan, when he testified before the House Financial Services Committee on October 21, 2008.[4] Tim testified that:

[3] http://www.finra.org/Newsroom/Statistics/index.htm

[4] Testimony of T. Timothy Ryan, Jr. President and CEO of the Securities Industry and Financial markets Association before the U.S. House of Representatives Committee on Financial Services Hearing on the Future of Financial Regulation, October 21, 2008.

"In our view, a sound regulatory regime must contain several key elements. First, it must be designed to minimize systemic risk to the financial system. Second, it must promote the safety and soundness of each regulated financial institution. Third, it must contain business conduct rules that promote fair dealing and investor protection. Fourth, it should be consistent from country to country. And finally, it is critical that the regulatory structure be as effective and efficient as possible. Regulation imposes meaningful costs on our financial system and over-regulation or inefficient regulation can diminish the competitiveness of markets vis-à-vis better regulated venues. Thus, well-crafted regulation—by which I mean regulation that achieves its goals and does so in a cost effective manner—is an important objective."

This last point is the key message that small broker-dealers wish to impart to Congress as it deliberates financial services reform. In short, well-crafted and thoughtful legislation is needed to avoid unintended consequences to firms that did not cause the current financial crisis. As I mentioned at the Committee on Small Business Regulatory Roundtable on June 16, 2009, Congress should consider including sunset provisions in financial services regulatory reform so that new legislation and regulations are reviewed to ensure that new rules are achieving the desired effect.

SIFMA supports strengthening consumer protection regulation as it relates to consumer credit products and lending practices. However, we are concerned that creating a new agency for these purposes might lead to wasteful and duplicative regulation while failing to deliver the hoped-for benefits due to the separation of consumer protection and prudential regulation.

SIFMA believes the Consumer Financial Protection Agency (the "CFPA") could inadvertently encroach on the jurisdiction of the SEC and CFTC. The Administration's White Paper states that the CFPA would provide consumer protection in the financial products and services markets, "except for investment products and services already regulated by the SEC or CFTC." Treasury officials have reiterated in various public statements that the CFPA is not intended to supersede the broad investor protection mandate of the two agencies. Nevertheless, as proposed, the CFPA's jurisdiction would be broad and have uncertain boundaries, potentially overlapping with those of the SEC and CFTC. We believe the Act should provide a full exclusion for investment products and services regulated by the SEC or the CFTC. As currently drafted, it excludes only a narrow list of activities of some of the persons regulated by the SEC, such as broker-dealers and investment advisers. Arguably the SEC's authority over transparency and disclosure, including its exclusive ability to mandate issuer disclosure in proxy statements and annual reports, also would be called into question. To avoid overlapping jurisdiction, we urge Congress to exclude from the jurisdiction of the CFPA any securities activity and any person, product or other activity that is regulated by the SEC or the CFTC.

There are two additional features of financial services reform that do affect my firm and our registered brokers and I would like to address them now.

Harmonization of Broker-Dealer and Investment Adviser Regulation

SIFMA has long advocated the modernization and harmonization of the disparate regulatory regimes for brokers, dealers, investment advisers and other financial intermediaries.[5] When broker-dealers and investment advisers engage in the identical service of providing personalized investment advice about securities to individual investors, they should be held to the same standard of care. Conversely, when broker-dealers are not providing personalized securities investment advice to individual investors (such as, for example, when broker-dealers simply execute orders for customers, or engage in market-making, underwriting or providing cash sweep services), there is no cause for modifying the existing, extensive regulatory regime that governs broker-dealers. We therefore welcome Treasury's newly proposed legislation, the "Investor Protection Act of 2009," which appears to acknowledge these important distinctions, and which would give the SEC the authority to establish rules for a new, uniform, federal standard.

Individual investors deserve – and SIFMA strongly supports – a new federal fiduciary standard of care that supersedes and improves upon the existing fiduciary standards, which have been unevenly developed and applied over the years, and which are susceptible to multiple and differing definitions and interpretations under existing federal and state law. Whatever label, if any, the SEC applies to this new federal standard, we

[5] See, e.g., Testimony of T. Timothy Ryan, Jr. before the U.S. Senate Committee on Banking, Housing and Urban Affairs in the March 10,2009 hearing titled "Enhancing Investor Protection and the Regulation of the Securities Markets," available at http://www.sifma.org/legislative/testimony/pdf/Ryan-03-10-2009.pdf.

must ensure that it functions as a unitary and exclusive standard that is uniformly and even-handedly applied – at the federal level – to both investment advisers and broker-dealers when they provide personalized investment advice about securities to individual investors. Congress successfully followed a similar approach when it restructured federal - state securities regulation through the National Securities Markets Improvement Act of 1996.

The hallmark of a new federal standard should be putting investors' interests first. At the very outset of the customer relationship, the duties, obligations and expectations of the customer and the financial service provider must be communicated and documented in clear and concise language as opposed to excessively technical and legalistic jargon. Broker-dealers and investment advisers alike should seek to avoid conflicts of interest. If they cannot, then they must effectively manage conflicts through clear, unambiguous disclosure and, as appropriate, investor consent.

A new federal standard should also protect investors by respecting and preserving investor choice, which is part of putting clients first. This should include investor choice to select, contract for and receive any of the wide range of products and services offered by their financial services provider, and investor choice to define or modify relationships with their financial services provider based on the investor's preference. In light of the numerous, diverse and investor beneficial products and services offered by broker-dealers that differ from, and are far beyond, those offered by today's investment advisers, a new federal standard should also recognize and preserve product and service innovation and capital formation. Yet another way to support choice, innovation and service is to provide firms with appropriate relief from the SEC's current prohibitions against principal trading, which in today's liquid and transparent markets no longer make sense and have had the effect of foreclosing opportunities for investors to obtain more favorable pricing on transactions because of the requirement of transaction- by-transaction consent. A new federal standard thus must be sufficiently flexible to be adapted to the products, services and advice chosen by the investor, and applied only in the context of providing personalized investment advice about securities to individual investors.

We recognize the important role that States play in protecting investors, and so we believe that any new legislation should make it clear that the States may investigate or bring enforcement actions for fraud to the extent consistent with the new standard of care. Any new legislation, however, should make clear that subjecting a financial professional to the new federal standard does not create any presumption that the financial professional is providing investment advice or is a fiduciary for purposes of any other federal or state laws. This enables broker-dealers to continue to provide investors choice of investment products, particularly in IRAs.

We also hope that harmonization would involve a reaffirmation that pre-dispute arbitration clauses in advisory and brokerage contracts are valid. In the past, the SEC has prohibited the inclusion of such clauses in advisory contracts on the grounds that they may confuse clients by causing them to believe they have waived their rights under the federal securities laws, which would violate the anti-fraud provisions of the Investment

Advisers Act of 1940.[6] As I will describe in further detail, this opposition to arbitration clauses is at odds with federal policy, judicial precedent and empirical evidence.

Pre-dispute Arbitration Clauses

Treasury has proposed giving the SEC authority to prohibit pre-dispute arbitration clauses in broker-dealer and investment advisory account agreements with retail customers, if it studies such clauses and concludes that their use harms investors. Similarly, the CFPA, as proposed, would have authority to prohibit or limit the use of arbitration clauses in consumer contracts to the extent that the CFPA finds such prohibition or limitation to be in the public interest and for the protection of consumers.

Congress has maintained a policy in favor of arbitration since the passage of the Federal Arbitration Act. The basis for this policy has been that arbitration simultaneously promotes fairness and efficiency. The U.S. Supreme Court has expressly approved the use of pre-dispute arbitration clauses.

SIFMA supports the idea of conducting further study of securities arbitration and pre-dispute arbitration clauses. In fact, we conducted our own study of the matter in October 2007.[7] Based on empirical data, we confirmed that securities arbitration is faster and less expensive than litigation. Small investors benefit in particular, as arbitration allows them

[6] McEldowney Financial Services, SEC No-Action Letter, Fed. Sec. L. Rep. (CCH) ¶ 78,373 (Oct. 17, 1986).

[7] Available at http://www.sifma.org/regulatory/pdf/arbitration-white-paper.pdf.

to pursue claims that they could not afford to litigate or that would be dismissed in court. Moreover, the percentage of claimants who recover in securities arbitration – either by award or settlement – has remained constant in recent years and average inflation-adjusted recoveries have been increasing. In sum, we found that the securities arbitration system properly protects investors, in part because it is subject to public oversight, regulatory oversight by multiple independent regulators and procedural rules specifically designed to benefit investors.

Pre-dispute arbitration clauses are vital to the securities arbitration system.
In fact, it is our view that prohibiting such clauses would essentially be tantamount to doing away with securities arbitration. Research shows that parties rarely agree to arbitrate after a dispute arises. Rather, a variety of tactical considerations tend to drive parties to litigate. Claimants' counsel may prefer litigation to drive up costs and induce nuisance settlements, use a judicial forum to seek publicity or attract other clients, or shop for forums thought to have anti-business jury pools. Securities firms may favor litigation to take advantage of their greater financial resources to the detriment of the small investor by engaging in extensive discovery or filing numerous motions.

Accordingly, the result of a voluntary, post-dispute arbitration approach is likely to be that most disputes end up in lengthier, costlier litigation. This outcome would likely result in a complete denial of justice for individuals with smaller claims. This cannot be the intended result of Treasury's proposal. We urge Congress to consider these factors in its deliberation over Treasury's pre-dispute arbitration clause proposals. We also suggest that further study of this subject might be particularly instructive.

Disparate Impact of Regulation on Small Firms

There are a number of issues and concerns in the area of regulation of smaller firms that I would like to bring to the attention of the Committee. While each of and by themselves may not seem significant, it is the cumulative impact of these regulations that are making it more difficult for smaller broker-dealers to survive. Each of these rules constitute a "hit" to my firm's bottom line. For example, when I opened my firm in 1995, the cost of my clearing contract was $3,000 per quarter. That expense has gone up ten fold to $30,000 per quarter, and is largely attributed to the costs of compliance with regulation. In 1995, the member application fees to FINRA for my firm was $3,000. Today, if I were opening a new firm, the application fees alone would exceed $27,000. My point is that the barriers to entry in the brokerage industry have increased significantly. Couple that with the increased costs of compliance and it is easy to see why smaller firms are struggling to stay in business.

Costs of Compliance

In 2006, SIFMA released a study on the costs of compliance in the securities industry. [8] While the overall percent of revenue spent on compliance was less for small firms than for larger firms, out-of-pocket costs for such items as compliance, accounting and audit services were over four times higher than for larger firm categories. Capital expenditures

[8] http://www.sifma.org/research/surveys/pdf/CostofComplianceSurveyReport.pdf

for small firms, for example, sophisticated, systems, to meet manage or monitor ongoing compliance, was highest for smaller firms. The survey highlights that because smaller firms have fewer internal resources than larger firms, small firms must rely on outside services to meet their growing compliance burden.

For example, for several years, small, non-public securities firms had received an exemption from the Sarbanes-Oxley requirement that a broker-dealer's financial audit be conducted by a registered public accounting firm under rules promulgated by the Public Company Accounting Oversight Board (PCAOB). This PCAOB small firm exemption expired in 2008. Now, SIFMA Small Firms Committee members report that their financial audit fees have increased significantly. While we understand and support the need for an effective audit regime to protect investors, maintain confidence in the markets, and prohibit fraud, many smaller firms in rural communities have had difficulties finding an accounting firm in their area that is willing to register under PCAOB. The scarcity of local PCAOB audit services further drives up the costs for local companies that have to seek out a PCAOB auditor outside of their communities. The average increase in financial audit fees reported to me is from $6,500 up to $8,000, with some small firms paying up to $30,000 for a PCAOB audit.

Earlier this year, the Securities Investor Protection Corporation (SIPC) increased their annual assessment to broker-dealers from $150 per year to one-quarter of one percent of gross revenue effective April 2009.[9] For one of my colleagues on the Small Firms

[9] http://www.sipc.org/media/release02Mar09.cfm

Committee, their SIPC assessment jumped from $150 to $40,000. This dramatic increase was not anticipated, impacted all firms, and for a smaller firm, can be devastating.

Recently, FINRA's Board of Governors voted to double the Personnel Assessment for registered persons and alter the formula for calculating its Gross Income Assessment. [10] In an economy where small firms are fighting to survive, FINRA has elected to impose additional fees to their member firms. Although these increases are now available for public comment through the SEC, FINRA did not request member comment on these additional levies.

Finally, the Municipal Securities Rulemaking Board (MSRB) also increased its annual fees. Many small firms execute a small number of municipal transactions every year. These firms maintain membership in the MSRB because they want to provide full service to their customers. But increased fees, coupled with the additional supervisory responsibilities placed on firms by FINRA for municipal securities compliance, are causing some firms to reconsider their municipal bond activity. The result is fewer firms serving municipal bond investors.

Presently, FINRA has proposed to the SEC to eliminate the Anti-Money Laundering (AML) Third Party Exemption for small firms.[11] Like the proposed FINRA assessment increases, FINRA did not put this proposal out for comment to FINRA members, but rather sent it to the SEC directly. Small firms already feel the burden of complying with

[10] http://www.sec.gov/rules/sro/finra/2009/34-60624.pdf

[11] http://www.sec.gov/rules/sro/finra.shtml

AML through the implementation of internal policies, procedures, supervisory tasks, and the utilization of scarce human resources in maintaining compliance with AML rules that our clearing firms comply with as well. Now, FINRA proposes that small firms be required to hire a third-party to test our AML procedures. Again, we have talked to many small firms and consultants who will provide these third-party services. For example, we expect that our AML audit will increase from between $2,500 to $4,000.

In addition, the SEC is proposing to ban placement agents in representing investment advisors, private equity, and other private investments to public pension funds.[12] This ban would have devastating effects on small firms that do not have the internal resources to hire marketing and fundraising staff on a full time basis and would place small broker-dealers at a competitive disadvantage compared to larger firms. Small firms would be forced to exit this business, or sacrifice other scare resources to continue this important service for public pension funds and the private equity investment management sector.

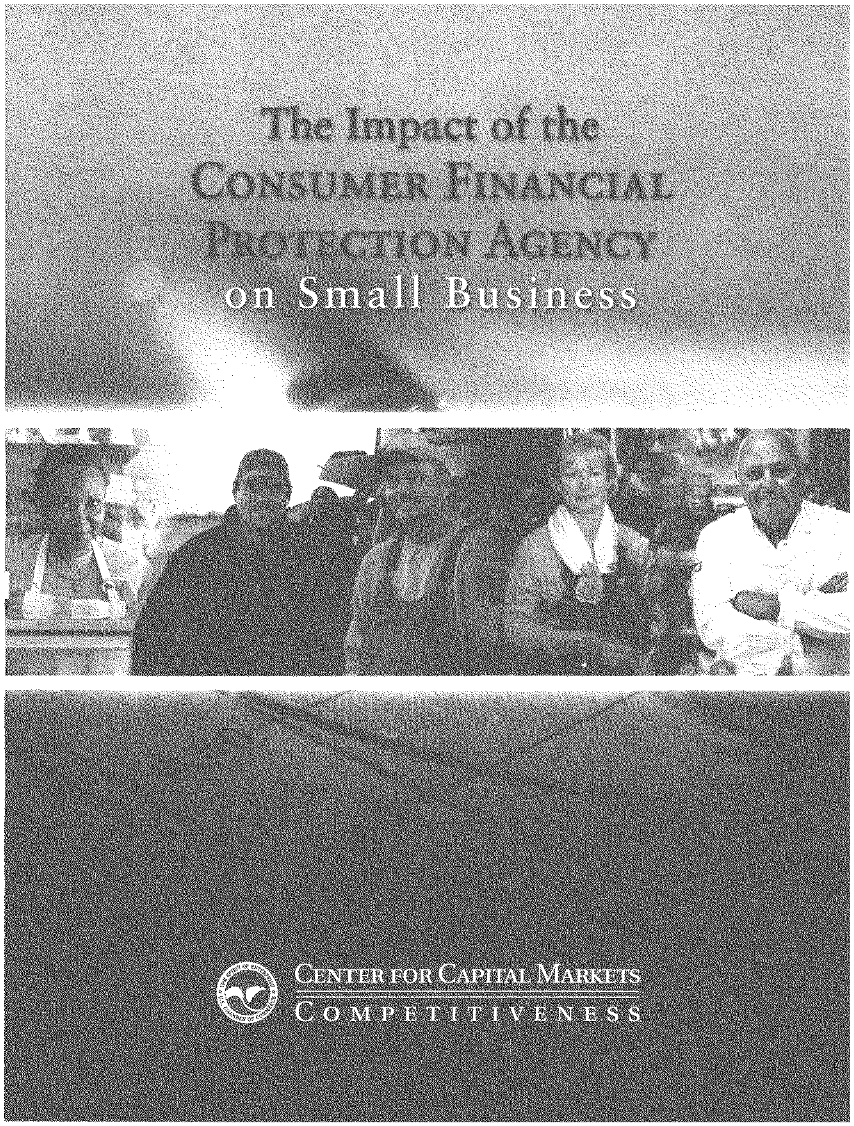
Taken together, the issues that I have outlined have created the perception among smaller firms of a "piling-on" by regulators that is pinching already narrow margins and the ability of firms to serve customers. The more that small firms spend on assessments and audit fees, the less small firms can spend on compliance enhancements, training and client service.

[12] http://www.sec.gov/rules/proposed/2009/ia-2910.pdf

My final comment relates to the Regulatory Flexibility Act,[13] or RegFlex. In accordance with RegFlex, federal agencies are required to include an Initial Regulatory Flexibility Analysis (IRFA) as part of the rule proposal process. SIFMA wishes to express its support for the Small Business Committee's initiative to correct deficiencies in RegFlex that will help ensure that small businesses are not overly burdened by regulations. We endorse your efforts to eliminate outdated regulations, ensure that agencies do not ignore the requirements of RegFlex, and compel agencies to consider foreseeable economic impacts of rules on small business.

Thank you, Madam Chairwoman and Ranking Member Graves, for allowing me to present SIFMA's views. We hope to continue our dialog on financial services regulatory reform and stand ready to assist this Committee with any of these matters.

[13] 5 U.S.C. 603


The Impact of the
Consumer Financial
Protection Agency
on Small Business
Center for Capital Markets
Competitiveness

The Impact of the Consumer Financial Protection Agency on Small Business

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September 23, 2009

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I. Introduction

The U.S. Department of the Treasury submitted draft legislation for the Consumer Financial Protection Agency Act of 2009 in July,[1] shortly after the Department proposed this new agency as part of the Administration's overall plan to reform financial services regulation.[2] The Consumer Financial Protection Agency (CFPA) would have significant powers to issue new regulations and toughen existing regulations of consumer financial products. It would also take over the responsibilities of enforcing existing consumer protection laws from federal regulators, including the Federal Reserve Board and the Federal Trade Commission. Under the Act, the CFPA's rules and regulations would function as a floor for individual states that could impose more stringent consumer protection regulations.[3]

Although the CFPA Act of 2009 is focused on consumers, it would also affect millions of small businesses. Most of the 26.7 million businesses in the United States, including the self-employed, rely on credit cards, home equity loans, auto title loans, and other sources of consumer lending to finance their business.[4] They use these loans for everything from obtaining seed capital to start their business, to managing monthly cash flows, and providing working capital. Many of these businesses do not have access to a commercial line of credit, often because they are too small or too new. Many others use consumer loan products to supplement commercial credit.

Small businesses account for significant employment and job growth. According to the Small Business Administration, employer firms with fewer than 100 employees accounted for more than 35% of U.S. employment in 2006.[5] Small businesses include many new firms that tend to grow quickly. These new firms account for a disproportionate share of the net new jobs that

[1] See United States Department of the Treasury, *Consumer Financial Protection Agency Act of 2009* (2009), available at http://www.financialstability.gov/docs/CFPA-Act.pdf [hereinafter CFPA Act] (proposing 2009 Consumer Financial Protection Agency legislation for passage by Congress).

[2] U.S. Department of the Treasury, Financial Regulatory Reform: A New Foundation, June 2009, available at http://www.financialstability.gov/docs/regs/FinalReport_web.pdf. The proposal is detailed at 55-75.

[3] *Ibid*, at 14.

[4] This figure, which is based on 2006 data, includes 20.7 million firms without employees and 6 million firms with employees. For the number of firms *see* Office of Advocacy, U.S, Small Business Administration, Non-employer Firms and Receipts by Industry, 2002-2007, available at http://www.sba.gov/advo/research/ind97_07.pdf. For the numbers of firms with employees, see Office of Advocacy, U.S, Small Business Administration, Firm Size Data, available at http://www.sba.gov/advo/research/st_06.pdf.

[5] See Office of Advocacy, U.S, Small Business Administration, Firm Size Data, available at http://www.sba.gov/advo/research/st_06.pdf. This figure is an underestimate since it excludes most individuals who have no employees besides themselves. When the number of non-employer firms are included and one assumes that each non-employer firm accounts for one job position, the share increases to 43%.

are added to the economy. Indeed, a Census Bureau study finds that new firms, most of which are small, accounted for most of the net additions to jobs in the United States between 1987 and 2005.[6] Moreover, some of these startups grow into very large firms. Microsoft®, for example, operated as a small firm for several years before growing rapidly into one of the largest corporations in the world based on market capitalization.[7] The well-being of small businesses is critical for the long-term performance of the economy, and the ability of small businesses to obtain credit is essential for their health.

In this economic analysis of the likely effect of the CFPA Act on small businesses, it is probable that if the U.S. Department of the Treasury's CFPA Act of 2009 were enacted, it would have a significantly adverse effect on small businesses by restricting their access to credit. Some would lose access to credit altogether. The businesses that would be most adversely affected would be the new businesses for which consumer loan products are a principal source of funding. As a result, the CFPA Act would inflict the greatest harm on those small businesses that account for a significant portion of the economy's net job growth. Fewer entrepreneurs would be able to start and expand their business. It does not go too far to suggest that the CFPA Act of 2009 could deny the credit that garage-based entrepreneurs need to create the next Apple® or Hewlett Packard®.[8]

The following four specific conclusions have been reached:

1. The CFPA would likely reduce an important source of credit to small businesses. This induced credit squeeze comes at a time when it is likely that small business credit will be already highly restricted as the lending industry digs out of the current financial crisis.
2. The CFPA credit squeeze would likely result in business closures, fewer startups, and slower growth. Overall, this would cost a significant number of jobs that would either be lost or not created. It is not possible to give an exact accounting of the magnitude of this impact, since counterfactual conditions are never directly observable, but there certainly would be an effect similar to opportunity costs.

[6] John Haltiwanger, Ron Jarmin, and Javier Miranda, "Business Formation and Dynamics by Business Age: Results from the New Business Dynamic Statistics," Working Paper, (May 2008), available at http://econweb.umd.edu/~haltiwan/bds_paper_CAED_may2008_may20.pdf.

[7] See Michael A. Cusumano and Richard W. Selby, *Microsoft Secrets, How the World's Most Powerful Software Company Creates Technology, Shapes Markets, and Manages People* (New York: The Free Press, 1995), at 2-7.

[8] Both Apple and HP started as small, garage-based firms. For Apple, see Jim Carlton, *Apple, The Inside Story of Intrigue, Egomania, and Business Blinders*, (Times Books, 1997) at 5, and for HP, see HP Company Information, "Rebuilding HP's Garage," available at http://www.hp.com/hpinfo/abouthp/histnfacts/garage/.

3. The CFPA adopts a "one-size-fits all" approach to consumer protection that ignores the fact that small businesses use consumer financial products in different ways than the average consumer. Rules that are designed to protect ordinary consumers are likely to impose collateral damages on informed and sophisticated small business owners who depend on consumer loan products.
4. Many suppliers of consumer financial services products are small firms such as community banks. The CFPA would harm these smaller suppliers because the new agency would impose fixed costs of compliance that weigh disproportionately on smaller firms, and because it would encourage product standardization that benefits larger firms. Also, only larger firms have the sophisticated legal staff to cope with waves of new regulations.

Section II of this paper describes the role of small businesses in the economy and, in particular, their role in generating new jobs. Sections III and IV summarize government data on how small businesses finance their operations and demonstrate their reliance on consumer loan products. Section V explains why the CFPA Act would likely reduce small business access to credit. Section VI presents conclusions.

II. The Role of Small Businesses in the Economy

U.S. Census Bureau data show that firms operating at a small scale of production and employment account in the aggregate for a substantial portion of U.S. jobs and output. Entrepreneurs, including those who are seeking to develop large, publicly traded firms, typically start small and grow over time. Many firms start with a self-employed, even part-time individual without any paid employees. Small firms play a significant role in economic innovation and growth, and often in driving American exports. Whether they are mature small firms or startups, small firms have tenuous access to capital, in part because they are too small to rely on the public debt and equity markets, and in part because they face moral hazards and asymmetric information problems that make lenders leery of providing credit to them.

A. Overview of Small Firms

There is a wide range of small firms in the U.S. economy. The smallest of these firms are individuals who work for themselves and who have no employees. There were 15 million self-employed individuals, most of whom did not have employees, in 2007 based on estimates from the U.S. Census Bureau.[9] These individuals include small contractors, home-based manufacturers, professionals working on their own, and a multitude of other small operations. About 75% of all firms with revenues in the United States did not have employees in 2000.[10]

Many businesses have a small number of employees. These include the local landscaper, retail shops ranging from the local jeweler to the neighborhood hardware store, franchises of big brands, restaurants, small manufacturers, and so on. Table 1 reports data on several employment size categories of these firms. Of businesses with employees, there were 5.4 million firms with fewer than 20 employees in 2006. They accounted for 18% of U.S. employment that year and 15% of payrolls. There were 5.9 million firms with fewer than 100 employees in 2006. They accounted for 35% of U.S. employment and 3% of payrolls.[11]

Table 1. Employment and annual payroll by firm size among firms with paid employees, 2006

Employment Size	*Firms*	*Percent of Total Employment*	*Percent of Total Annual Payroll ($1,000)*
<20	5,377,631	18.0%	15.2%
20-99	535,865	17.6%	15.5%
100-499	90,560	14.6%	13.8%
500+	18,071	49.8%	55.6%

Note: Employment is measured in March, thus some firms (startups after March, closures before March, and seasonal firms) will have zero employment and some annual payroll.
Source: Office of Advocacy, U.S, Small Business Administration, Firm Size Data, available at http://www.sba.gov/advo/research/st_06.pdf.

[9] Of those, 9.8 million are self-employed in their own unincorporated business, and 5.1 million in their own incorporated businesses. Some of the self-employees probably own more than one firm and that can explain why the number of firms with no employees is higher than the number of self-employed. See U.S. Census, American Community Survey 3-year Estimate, 2005-2007, available at http://factfinder.census.gov/servlet/DatasetMainPageServlet?_program=ACS.

[10] Although this figure is based on 2000 data, there is no reason to believe that the proportion has changed significantly since then. See Figure 6 in Steven Davis, John Haltiwanger, and Ron Jarmin, "Turmoil and Growth: Young Businesses, Economic Churning and Productivity Gains," Ewing Marion Kauffman Foundation (June 2008), available at http://www.kauffman.org/uploadedFiles/TurmoilandGrowth060208.pdf.

[11] These numbers are an understatement since they exclude self employed with no employees for which no payroll data are available. Employments and Payroll data from Office of Advocacy, U.S, Small Business Administration, Firm Size Data, available at http://www.sba.gov/advo/research/st_06.pdf.

Small firms are present in all industries although they are more common in some than in others. Table 2 shows the percentage of employment in firms with fewer than 10, 20, 100, and 500 employees by major industry. The share of employment in firms with fewer than 20 employees ranges from a high of 51.9 % in Agriculture to a low of 0.5 % in the Management of Companies and Enterprises industry.

Table 2. Share of employment size by major industry

Industry	*Total Employment*	*<10*	*<20*	*<100*	*<500*
Agriculture, Forestry, Fishing, Hunting	165,661	36.4%	51.9%	74.3%	90.7%
Mining	554,333	7.1%	13.0%	29.7%	44.1%
Utilities	614,427	2.3%	3.5%	9.7%	17.8%
Construction	7,338,799	22.7%	36.8%	67.7%	85.4%
Manufacturing	13,631,683	4.1%	8.7%	25.8%	44.4%
Wholesale Trade	6,030,647	11.6%	20.4%	43.5%	61.1%
Retail Trade	15,767,866	11.1%	17.9%	31.7%	40.0%
Transportation and Warehousing	4,306,405	7.5%	12.6%	26.0%	37.8%
Information	3,396,246	4.1%	7.4%	16.8%	26.3%
Finance and Insurance	6,647,098	8.4%	11.9%	21.6%	32.9%
Real Estate and Rental and Leasing	2,216,803	25.8%	35.5%	53.9%	68.6%
Professional, Scientific, and Technical Services	8,054,094	18.8%	28.5%	47.4%	61.6%
Management of Companies and Enterprises	2,915,644	0.3%	0.5%	2.9%	12.1%
Administrative and Support	10,003,626	6.2%	10.3%	21.7%	37.3%
Educational Services	2,979,514	4.4%	8.7%	26.8%	44.8%
Health Care and Social Assistance	16,451,361	9.1%	15.5%	29.7%	48.3%
Arts, Entertainment, and Recreation	1,973,655	10.2%	18.4%	23.4%	45.4%
Accommodation and Food Services	11,381,226	8.1%	18.1%	45.8%	60.2%
Other Services (except Public Administration)	5,458,558	30.5%	46.7%	73.8%	85.4%

Source: Office of Advocacy, U.S. Small Business Administration,
based on data provided by the U.S. Census Bureau. See Office of Advocacy, U.S, Small Business Administration, Major Industries by NAJCs Codes: Private Employer Firms, Establishments, Employment, and Annual Payroll by Firm Size http://www.sba.gov/advo/research/us98_01_06n_mi.pdf.

B. Small Firms, New Firms, and Job Creation

Small firms play an important role in creating new jobs for the economy, in keeping the unemployment rate low, and providing an employment cushion when unemployment rises. In 2006, more than 800,000 new businesses were created in the United States.[12] Of those, more than 642,000 had fewer than 20 employees.[13] Many of these businesses hire workers and expand over

[12] In 2006 there were 824,921 new establishments. Latest Statistics (2005-2006) on the change in U.S. Business Employment are available at http://www2.census.gov/econ/susb/data/dynamic/0506/us_state_totals_emplchange_2005-2006.xls. More recent Census data on US businesses are not available.

[13] *Ibid.*

time. Although the failure rate among these businesses is high overall, these new firms contribute a significant portion of the job growth in the economy.[14]

The importance of small businesses for job creation is evidenced by a further breakdown of these and related figures of net job creation. For example, in 2005, firms with fewer than five employees in the previous year accounted for 36.7% of total net job creation, and those with fewer than 20 employees accounted for 45.3% of net job creation.[15] Moreover, it turns out that most of the net job generation comes primarily from startups. The Census Bureau shows that in 2005, startups generated more than 3.6 million net jobs out of 2.5 million total net jobs created.[16] And of all startups, the smallest size firms create most of the new jobs.[17] Haltiwanger, Jarmin and Miranda find that between 1987 and 2005 new firms accounted for most of the net job creation in the United States. As shown in Figure 1, most of the net jobs came from startups. For example, startups with fewer than 20 employees account for 86.7% of net job creation. Many new firms go through a phase where the owner starts the firm and develops it before hiring workers. Self-employment therefore provides a nurturing stage for businesses that eventually expands and generates significant net jobs.[18]

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[14] See US Census Bureau, Business Dynamics Statistics Briefing: High Growth and Failure of Young Firms, Figure 1 at.1, available at http://www.ces.census.gov/docs/bds/bds_high_growth_and_failure_ces.pdf.

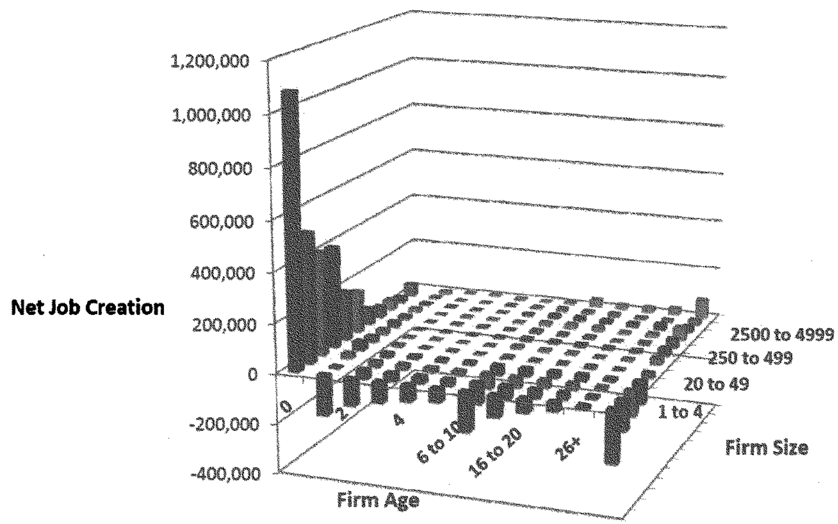
[15] The formation of new firms and the expansion of existing ones over time contribute to new job creation. On the other hand, firm closures and the contraction of employment lead to job losses. Net job creation equals the difference between job creation and destruction. For statistics see Dynamic Business Statistics that have numbers of business openings and closings, startups, job creation and job destruction by firms size. In 2005, total net job creation was 2.4 million, 910,431 of those were created by firms that had less than five employees in 2004. See US. Census Bureau, Dynamic Business Statistics, BDS Dataset List, Initial Firm Size, available at http://www.ces.census.gov/index.php/bds/bds_database_list.

[16] Net job creation by new firms exceeds net total job creation since we observe negative job creation by all non-startups, due to job destruction. Calculations are based on data from the Business Dynamic Statistics. See US. Census Bureau, Dynamic Business Statistics, BDS Dataset List, Firm Age Dataset, available at http://www.ces.census.gov/index.php/bds/bds_database_list.

[17] John Haltiwanger, Ron Jarmin and Javier Miranda, "Business Dynamics Statistics Briefing: Jobs Created from Business Startups in the United States," Ewing Marion Kauffman Foundation (January 2009), available at http://ssrn.com/abstract=1352538.

[18] See Stefan Fölster, "Do Entrepreneurs Create Jobs," *Small Business Economics* 14 (2000):137-148; David B. Audretsch, Max C. Keilbach, Erik Lehmann, *Entrepreneurship and Economic Growth* (Oxford University Press, 2006)

Figure 1. Net job creation by firm and by size



Note: Net job creation is averaged over the years 1987-2005, by firm size and firm age.
Source: US. Census Bureau, Dynamic Business Statistics, BDS Dataset List, Firm Age By Firm Size, available at http://www.ces.census.gov/index.php/bds/bds_database_list. See also Figure 15 in John Haltiwanger, Ron Jarmin, and Javier Miranda, "Business Formation and Dynamics by Business Age: Results from the New Business Dynamic Statistics," Working Paper, (May 2008), available at http://econweb.umd.edu/~haltiwan/bds_paper_CAED_may2008_may20.pdf.

C. Startups and High Growth Companies

The last three decades have been marked by the formation of new companies that create totally new products or services. These include firms that started as part of the information-technology revolution that began in the mid 1970s with the decline in microprocessor prices, the Internet revolution that began in the early 1990s as a result of the development of web technologies, and other technological changes such as the biotech revolution. Table 3 shows the 50 largest companies by market capitalization in 2008. Of these, 10, accounting for 18% of the market capitalization of the top 50, did not exist in 1975. Of course many other highly successful firms that were started over this time period such as well publicized YouTube and Facebook, to take two recent examples, do not appear on this list and some of the established firms have increased their market capitalization by buying new firms.

Table 3. The 50 largest companies by market capitalization, 2008

Rank	Company	Market Capitalization, $M	Year Founded
1	Exxon Mobil	406,067	1870
2	Wal-Mart Stores	219,898	1962
3	Procter & Gamble	184,576	1837
4	Microsoft	172,930	1975
5	AT&T	167,950	1885
6	Johnson & Johnson	166,002	1886
7	General Electric	161,278	1911
8	Chevron	150,292	1879
9	Berkshire Hathaway	149,600	1888
10	Pfizer	119,417	1849
11	JP Morgan Chase	117,681	1823
12	IBM	113,065	1896
13	Coca-Cola	104,735	1886
14	Wells Fargo	98,028	1852
15	Verizon Communications	96,292	1918*
16	Cisco Systems	95,438	1984
17	Oracle Corporation	89,469	1977
18	Philip Morris International	88,022	1881
19	Hewlett-Packard	87,684	1939
20	Genentech	87,224	1976
21	Pepsico	85,064	1958
22	Abbott Laboratories	82,808	1888
23	Intel Corporation	81,539	1968
24	ConocoPhillips	77,224	1875
25	Apple	75,871	1976
26	Google	73,693	1998
27	Bank of America	70,647	1929
28	McDonald's	69,314	1940
29	Merck	64,271	1917
30	Amgen	61,187	1980
31	Qualcomm	59,316	1985
32	United Technologies	50,953	1929
33	Schlumberger	50,634	1926
34	Wyeth	49,944	1860
35	Occidental Petroleum	48,585	1920
36	Comcast	47,860	1963
37	Gilead Sciences	46,564	1987
38	Bristol-Myers-Squibb	46,026	1887
39	Eli Lilly	45,785	1879
40	U. S. Bancorp	43,569	1890
41	Walt Disney	42,000	1923
42	CVS/Caremark	41,277	1963
43	3M	39,873	1902
44	Kraft Foods	39,446	1903
45	Home Depot	39,029	1978
46	Monsanto	38,548	1901
47	United Parcel Service	37,372	1907
48	Exelon	36,587	1887
49	Citigroup	36,566	1812
50	Time Warner	36,090	1922**

Note: * Verizon Communications was formed by the merger of GTE with Bell Atlantic Corporation in 2000. GTE started in 1918; Bell Atlantic was one of the original several Regional Bell Operating Companies that were divested from AT&T in 1984 after an antitrust decree. See "History of Verizon Communications Inc," Verizon Media Relations, February 2009, available at http://investor.verizon.com/profile/history/pdf/verizonhistorictimeline.pdf.

** Time Warner came out of the merger between Time Inc. and Warner Communications in 1990. Time Inc. was founded in1923. See chronology of key events in the history of Time Warner Inc. and America Online Inc at http://money.cnn.com/2000/01/10/deals/aol_warner/timeline.htm.

Market value is estimated at December 31, 2008 prices.

Source: FT Global 500 December 2008, available at http://www.ft.com/reports/ft5002008.

These firms typically started out small. There is no systematic data on the start-up phases of these successful firms but a few examples remind the reader of the early beginnings of these firms. Google® started in 1995 when Larry Page and Sergey Brin collaborated to develop a search engine. It was not until more than two years later that they had any investment capital or paid employees.[19] Microsoft® was founded in 1975 by Bill Gates and Paul Allen, who started by writing programs for the early Apple® and Commodore® machines and expanded BASIC programming language to run on microcomputers. The company started with just three employees and revenue of $16,000 in the first year.[20] The start-up funds came mainly from personal finances. As Bill Gates described, "...[f]rom the start Paul and I funded everything ourselves. Each of us had saved some money. Paul had been paid well at Honeywell, and some of the money I invested in our startup came from late-night poker games in the dorm."[21] Hewlett and Packard started working together with $538 and a used Sears Craftsman drill press in 1938 and did not even formalize the partnership until the next year.[22] Ben and Jerry's used $12,000 in cash, with $4,000 of it borrowed, to open their first ice cream shop in 1977.[23]

III. Access to Capital and Small Firms

Small firms typically have trouble borrowing money. They are what economists call "liquidity constrained."[24] They either cannot borrow any money, they cannot borrow as much as they need at reasonable rates, or they can only borrow at exorbitant rates.

Most new small firms do not have a credit history and often do not even have a history of revenue and profits to show to lenders. They have difficulty borrowing money from traditional sources unless they can secure it with collateral, which they generally do not have in their business. Such firms typically turn to several alternative sources depending on their situation. They include financing themselves from personal savings, turning to friends and relatives, relying on consumer loan products, or in the cases of entrepreneurial startups, seeking angel- or venture-capital funding.

[19] Google Corporate Information, "Google Milestones," available at http://www.google.com/corporate/history.html.

[20] See Cusumano and Selby, *supra* note 7, at 3.

[21] Bill Gates, and Nathan Myhrvold, *The Road Ahead* (Penguin Books, 1996), at 19.

[22] HP Company Information, "Rebuilding HP's Garage," available at http://www.hp.com/hpinfo/abouthp/histnfacts/garage/.

[23] Ben & Jerry's Company History, available at http://www.benjerry.com/company/history/.

[24] David S. Evans and Boyan Jovanovic, "An Estimated Model of Entrepreneurial Choice under Liquidity Constraints," *Journal of Political Economy* 97 (1989): 808-827; D. Holtz-Eakin, D. Joulfaian, and H. S. Rosen, "Sticking it out: Entrepreneurial Survival and Liquidity Constraints," *Journal of Political Economy*, 102 (1994):53-75; D. Blanchflower, and A. Oswald, "What makes an entrepreneur?", *Journal of Labor Economics*, 16 (1998) :26-60; Steven M. Fazzari, R. Glenn Hubbard, and Bruce C. Petersen, "Financing Constraints and Corporate Investment." *Brookings Papers on Economic Activity* 1 (1988): 141-205.

Many established small firms also have trouble borrowing. Lending to small firms can be risky because they have a high failure rate and are therefore more likely to run into arrears or default. That is why banks very quickly cut off loans to many small businesses with the onset of the financial crisis.[25]

The *Surveys of Small Business Finance* conducted by the Federal Reserve Board show the extent to which small firms have difficulty borrowing.[26] Taken from this source, Table 4 shows that close to 20% of firms with fewer than 20 employees did not even try to apply for credit because they expected to be denied. Of those that applied multiple times for credit, firms with fewer than 20 employees had at least one application turned down about one third of the time. These figures are for 2003 when the U.S. economy was robust. One would expect that small businesses would be more credit-constrained in poor economic times such as the current environment.

[25] Report to the Congress on the Availability of Credit to Small Business, Board of Governors of the Federal Reserve System, October 2007, p. 21.

[26] The Federal Reserve Board collects information on the use of various financing methods periodically. Surveys were done in 1987, 1993, 1998 and 2003. I rely on the 2003 survey, which is the most recent one. The survey is based on data from 4420 small businesses. The Federal Reserve Board takes a stratified sample of businesses and then weights the data to provide population estimates. See Lieu N. Hazelwood, Traci L. Mach, and John D. Wolken, "Alternative Methods of Unit Nonresponse Weighting Adjustments: An Application from the 2003 Survey of Small Business Finances," Federal Reserve Board - Finance and Economics Discussion Series, 2007-10, available at http://www.federalreserve.gov/pubs/feds/2007/200710/200710abs.html.

Table 4. Percentage of small businesses with various types of outcomes in terms of credit applications, 2003, by firm size

		Applied once		Applied multiple times			
Number of employees(4)	*Applied for credit*	*Share of all firms*	*Application approved(1)*	*Share of all firms*	*All applications approved(2)*	*Some applications approved(3)*	*Did not apply for fear of denial*
All firms	21.4	12.3	87.1	9.1	65.0	17.1	17.9
0-1	13.5	8.8	89.4	4.7	67.0	17.8	17.8
2-4	18.1	11.3	81.5	6.7	62.7	18.3	18.7
5-9	26.2	14.5	91.2	11.6	54.4	15.9	20.0
10-19	29.8	14.4	88.3	15.4	66.2	23.2	17.3
20-49	31.0	16.1	89.4	14.9	77.5	12.7	10.6
50-99	39.2	20.0	98.5	19.1	94.8	1.9	11.3
100-499	41.7	15.5	91.3	26.1	90.6	7.8	9.5

Note: (1) Percent based on small businesses that applied once for credit. (2) Percent based on small businesses that applied multiple times for credit. (3) Survey respondents were asked if they had foregone applying for credit at any point in the previous four years (2000-03) for fear of denial. (4). Number of owners working in the business plus number of full- and part-time workers. Survey respondents were asked about their credit application experience from 1996 to 1998. Data are weighted to adjust for differences in sampling and response rates and reflect population rather than sample measures.

Source: Table A.9. in "Report to the Congress on the Availability of Credit to Small Business," Board of Governors of the Federal Reserve System, October 2007, available at http://www.federalreserve.gov/boarddocs/rptcongress/smallbusinesscredit/sbfreport2007.pdf

Table 5 shows similar statistics based on the age of the firm. The results are striking for the firms that are less than five years old and that, as seen in Figure 1, account for a significant portion of net job growth. More than one quarter of these firms did not even bother applying for credit as businesses because they expected to be denied. Of those that applied once, about 15% were denied credit. Of those that applied multiple times, more than half had at least one application rejected.

Table 5. Percentage of small businesses with various types of outcomes in terms of credit applications, 2003, by age of firm

		Applied once		Applied multiple times			
Years under current owner	Applied for credit	Share of all firms	Application approved[1]	Share of all firms	All applications approved[2]	Some applications approved[3]	Did not apply for fear of denial[4]
0-4	22.6	14.6	84.5	8.0	48.0	20.0	26.5
5-9	21.6	11.1	87.3	10.5	57.0	18.4	22.1
10-14	22.2	12.9	85.7	9.3	66.5	22.6	18.9
15-19	21.8	13.2	91.2	8.6	73.3	13.5	16.0
20-24	19.5	10.9	89.9	8.6	76.3	12.2	11.3
25+	19.8	10.6	86.8	9.2	80.1	12.5	7.3

Notes: (1) Percent based on small businesses that applied once for credit. (2) Percent based on small businesses that applied multiple times for credit. (3) Survey respondents were asked if they had forgone applying for credit at any point in the previous four years (2000-03) for fear of denial. (4). Number of owners working in the business plus number of full- and part-time workers. Survey respondents were asked about their credit application experience from 1996 to 1998. Data are weighted to adjust for differences in sampling and response rates and reflect population rather than sample measures.

Source: Table A.9. in "Report to the Congress on the Availability of Credit to Small Business," Board of Governors of the Federal Reserve System, October 2007, available at http://www.federalreserve.gov/boarddocs/rptcongress/smallbusinesscredit/sbfreport2007.pdf.

IV. Small Businesses and the Use of Consumer Lending Products

Almost 90% of small businesses used some form of credit in 2003 based on data from the Federal Reserve Board's SSBF.[27] Small business owners had almost $1.3 trillion in loans outstanding during that year.[28] Table 6 summarizes the sources of credit for these firms by size level. Several aspects of these results are noteworthy. As one would expect, given the difficulty that small firms have in getting access to credit, the extent of the use of credit increases as firms get larger, this is also likely to be a result of their getting older as well. Only 81% of firms without employees have credit compared with 97% of firms with 20 or more employees. About 60% of the firms have a traditional business loan. Standard sources of working capital such as lines of credit are used the least by small firms. Only 42.5% of firms without employees have a

[27] See "Small Business in Focus: Finance, A Compendium of Research by the Small Business Administration's Office of Advocacy," Office of Advocacy, U.S. Small Business Administration, July 2009, available at http://www.sba.gov/ADVO/research/09finfocus.pdf.

[28] See Table A in "Small Business and Micro Business Lending in the United States, for Data Years 2003-2004," Office of Advocacy, US Small Business Administration, November 2005.

traditional loan and 59.1% of firms with one to four employees. That percentage increases to 93.8% for firms with 100 to 499 employees.

Table 6. Share of all small firms using credit, by credit type 2003

		Firms by Employment Size					
Loan Type	*Any firm*	*0*	*1-4*	*5-9*	*10-19*	*20-99*	*100-499*
Any credit	89.0	80.9	89.9	94.3	96.5	97.2	97.7
Any traditional loan	60.4	42.5	59.1	74.7	77.1	84.1	93.8
Line of credit	34.3	17.9	32.5	45.3	49.5	60.2	82.5
Mortgage	13.3	6.8	14.8	15.4	19.0	20.9	28.1
Vehicle loan	25.5	17.2	24.5	31.7	35.9	36.3	35.7
Equipment loan	10.3	4.1	6.2	14.9	20.2	26.6	32.4
Lease	8.7	4.4	7.2	12.3	12.5	17.7	28.0
Other	10.1	7.2	7.5	14.1	15.3	16.0	18.7
Any nontraditional loan	80.0	70.9	82.2	85.3	89.6	85.3	87.1
Owner loan	16.8	4.7	17.0	25.6	27.4	32.8	27.8
Personal credit card	46.7	49.6	47.6	47.1	44.8	34.3	32.1
Business credit card	48.1	33.3	50.1	59.3	58.4	62.6	71.7

Source: Charles Ou and Victoria Williams, "Lending to Small Businesses by Financial Institutions in the United States," in *Small Businesses in Focus: Finance, A Compendium of Research by the Small Business Administration's Office of Advocacy*, (July, 2009).

The remainder of this section focuses on the extent to which small firms rely on consumer lending products for sources of credit.

A. Personal Credit Cards

Small businesses use credit cards extensively as shown in Table 7, which is based on 2003 data for the Federal Reserve's Survey of Small Business Finances. About 77% of all small businesses used at least one credit card in 2003. About 47% used personal credit cards and about 48% relied on business credit cards. Personal credit card use was most prevalent among the small firms with fewer than 10 employees, especially the smallest firms. Almost half of these firms relied on a personal credit card. Interestingly, almost one third of firms with 100 to 500 employees also relied in part on personal credit cards.[29] The widespread use of cards is not surprising. This source of financing is much easier to obtain than others. It does not require submitting a business plan to a bank or trying to convince family members to lend money.

[29] Furthermore, Scott III discusses that small businesses have limited access to formal credit markets, which has led to a dramatic increase in the use of credit cards to subsidize their insufficient liquidity. Credit cards are useful for small businesses because of their near-universal acceptance, accessibility and anonymity. See Robert H. Scott III, "The Use of Credit Card Debt by New Firms: Sixth in a Series of Reports Using Data from the Kauffman Firm Survey," (August 4, 2009) *available at* http://ssrn.com/abstract=1446780.

Credit cards are used in two ways. First, they provide small businesses with an essentially free source of working capital. Small businesses can use these cards to charge things over the course of the month then pay the bills in full. This gives these businesses free float of about two weeks on average. While this does not seem like much, that free float is likely to be very important to small businesses to manage their cash flow. The cost of this method of financing is close to zero for most credit cards. About 70% of businesses with fewer than 10 employees pay the balances in full as shown in Table 7. That increases to more than 90% for firms with 100 to 500 employees.

Second, credit cards provide a source of credit for some businesses in the form of a revolving loan. About 30% of the smallest businesses avail themselves of this credit feature. Given the difficulty that these very small businesses have in obtaining other sources of capital this source of lending is likely to be important to many of them.

Table 7. Use of credit cards by small businesses, 2003, percentage of all small companies, by firm size

Number of employees	*Any*	*Personal*	*Business*	*Paid balance*
All firms	77.3	46.7	48.1	70.7
0-1	69.5	48.6	32.0	69.6
2-4	76.4	48.1	45.7	65.9
5-9	81.0	47.8	56.8	68.5
10-19	85.0	45.6	59.7	79.4
20-49	81.5	34.4	61.7	85.2
50-99	81.9	34.6	63.5	93.9
100-499	82.8	32.2	71.4	92.4

Source: Table 4 in "Report to the Congress on the Availability of Credit to Small Business," Board of Governors of the Federal Reserve System, October 2007, available at http://www.federalreserve.gov/boarddocs/rptcongress/smallbusinesscredit/sbfreport2007.pdf.

Looking at credit cards from the consumer side reveals consistent findings. Research by Blanchflower and Evans demonstrates that the availability of credit cards relaxes the liquidity constraints that small businesses face in the U.S.[30] Using data from the Survey of Consumer Finances, they find that households headed by self-employed individuals tend to have credit cards more frequently than households overall. For example, in 2001, 86% of self-employed households had credit cards while 76% of wage workers did. In addition, businesses that had

[30] See David Blanchflower and David S. Evans, "The Role of Credit Cards in Providing Financing for Small Businesses," *The Payment Card Economics Review* 2 (Winter 2004):77-95, available at http://ssrn.com/abstract=1474450.

been denied credit were more likely to have personal and business credit cards and to charge more on those cards than businesses that were not denied credit.

As noted earlier most jobs generated in the U.S. economy come from new firms that usually start out small and grow. Although systematic data are not available, it seems highly likely that personal credit cards are a critical source of capital for these businesses. These new businesses typically cannot obtain traditional business loans because their businesses have no credit history. Lenders are understandably reluctant to lend money to such businesses. New firms have a high rate of failure—about one-third of businesses with employees fail in the first two years, and 56% fail within four years.[31] At the same time, there is very little information available to the lender on the likely success of the business and its potential ability to repay loans. As a result, new small businesses cannot obtain significant funding from traditional commercial lenders unless the owners can provide collateral. From a common sense perspective, if you are starting a new business and need to buy computers, office equipment, and supplies, you are most likely to put those charges on your personal credit cards. Most people have personal credit cards with lines of credit, and they can use those lines of credit to start a new small business instead of charging consumer goods. The data above indicate that, in fact, that is what many small businesses do—especially those with no employees.

Several popular accounts of the start of small businesses demonstrate the importance of personal credit cards in helping new firms establish a financial foundation. Sergey Brin and Larry Page used plastic to start Google® in the mid 1990s. They ran their credit cards to the maximum and, mindful of their limits, they chose to buy used computers and use open-source software. The two worked on the BackRub® search engine, then set out to sell licenses to the technology. Their immediate goal was to move out of the dorms and pay off the credit card debt they had amassed trying to expand their network.[32] YouTube® founders, Steve Chen and Chad Hurle also relied on personal finances in the early days of their video-sharing business. As one industry observer noted, investment from Sequoia Capital® came "...just in time for Steve to avoid having to increase his credit-card limit yet again to pay for various tech expenses."[33]

[31] Amy E. Knaup, "Survival and Longevity in the Business Employment Dynamics Data", *Monthly Labor Review* 128 (2005):50.

[32] Laurie J. Flynn, "The Google I.P.O.: The Founders; 2 Wild and Crazy Guys (Soon to be Billionaires), and Hoping to Keep It That Way," *The New York Times*, April 30, 2004, available at http://www.nytimes.com/2004/04/30/business/google-ipo-founders-2-wild-crazy-guys-soon-be-billionaires-hoping-keep-it-that.html.

[33] See John Cloud, "The Gurus of You Tube," *The Time Magazine*, December 16, 2006, available at http://www.time.com/time/magazine/article/0,9171,1570721,00.html.

B. Home Equity Loans

The 2007 Survey of Consumer Finances (2007 SCF) reveals a few more dimensions of the way self-employed individuals—typically owners with no employees—rely on various credit products. Families headed by a self-employed individual had larger amounts of debt secured by residential property, on average, than families overall in 2007. For example, families overall held about $107,000 in debt secured by the primary residence, whereas self-employed families held $135,000 on average. Families overall held about $100,000 in debt secured by other residential property, whereas families headed by a self-employed individual held $151,600 on average.[34]

Families where the head was self-employed were more likely than families overall to have a home-equity line of credit; 20.4% of self-employed families had one as opposed to 12.6% overall in 2007.[35] Furthermore, families headed by a self-employed individual were also more likely to be borrowing against that line—11% of self-employed families versus 8.5% of all families in 2007.[36] In addition, although borrowing on lines of credit other than a home equity line was quite unusual among families in 2007, it was somewhat more common among families headed by a self-employed individual.[37]

The use of real estate as collateral in securing loans for business needs is further corroborated by actual loan data. For example, about 90% of loans approved by Southern California Reinvestment CDFI®, a community development organization in Santa Ana that lends to small companies, are backed in part by the borrower's residential real estate.[38]

The availability of home-secured loans for business financing has been considered a driver of businesses in the United States. As Hernando de Soto remarked,

[34] Home-secured debt consists of first-lien and junior-lien mortgages and home-equity lines of credit. See Table 13 B in Brian Bucks, Arthur Kennickell, Traci Mach, and Kevin B. Moore, "Changes in U.S. Family Finances from 2004 to 2007: Evidence from the Survey of Consumer Finances," Federal Reserve Bulletin February 2009, available at http://www.federalreserve.gov/pubs/bulletin/2009/pdf/scf09.pdf.

[35] *Ibid.*, at A44.

[36] *Ibid.*, at A44.

[37] *Ibid.*, at A47.

[38] Amy Barrett and Jeremy Quittner, "Hungry for Cash, Startup Capital Grows Scarce," BusinessWeek, October/November 2007, available at http://www.businessweek.com/magazine/content/07_44/b4056413.htm.

> The single most important source of funds for new businesses in the United States is a mortgage on the entrepreneur's house. These assets can also provide a link to the owner's credit history, an accountable address for the collection of debts and taxes, the basis for the creation of reliable and universal public utilities, and a foundation for the creation of securities (like mortgage-backed bonds) that can then be rediscounted and sold in secondary markets. By this process, the West injects life into assets and makes them generate capital.[39]

C. Other Consumer Credit Products

Small businesses sometimes use consumer credit products that might be considered fringe financial products. For instance, small independent businesses such as landscaping, plumbing, and handyman services may use auto title loans as a source of short-term working capital. An independent landscaping company may need several hundred dollars to purchase sod and bushes for a job, or for temporary cash to meet payroll while finishing a job, or awaiting payment. In these cases, the proprietor may pledge his pick-up truck to obtain the necessary capital to buy the supplies to complete the job. Then when the job is complete—often only days later—payment is made and the owner can redeem the collateral. The likelihood of default and repossession is extremely low, and the likelihood of revolving the loan is very low as well.[40] Since many of these businesses may be seasonal and volatile in nature, using short-term credit (even at relatively high cost) can be more useful and appropriate than long-term bank loans or other types of credit.

Title loan industry members report that these small independent businesses that use title loans as a source of short-term operating capital may be as much as 25 to 30% of their customer base and an even greater percentage of loan amount and value because they are larger and more frequent customers, often borrowing for very short time periods of a few days.[41] Title lending may be a useful source of credit for these independent businesses. Title loans usually are closed

[39] Hernando de Soto, *The Mystery of the Capital: Why Capitalism Triumphs in the West and Fails Everywhere Else* (Basic Books, 2003) at 6; reprinted by The New York Times, Online Edition, available at http://www.nytimes.com/books/first/d/desoto-capital.html.

[40] See Todd J. Zywicki, "Consumer Welfare and the Regulation of Title Pledge Lending," Working Paper (September 2009).

[41] *Ibid.*

on the spot within 30 minutes, providing the small business proprietor with direct access to cash. Bank loans, by contrast, often require a lengthy underwriting process that delays immediate access to cash. Moreover, title loans only charge interest and do not charge up-front fees or prepayment penalties; thus, they are uniquely useful for those who expect to repay the loan within a few days or a week. Independent businesses may at times use several title loans in sequence, making it appear that they are in a debt trap of sorts as can be the case with other short-term loan products. In reality, they are engaging in a series of independent transactions to gain working capital for a series of independent jobs.[42]

D. Use of Consumer Financial Products by Small Businesses

In sum, small businesses, especially those with fewer than 20 employees, rely extensively on consumer lending products. These businesses use these sources of credit in very different ways than do households. Small firms, for example, are less likely to use their credit cards to revolve than are regular households. Even for firms with no employees, 70.7% pay off their balances at the end of the month[43] compared with 53.8% for consumers.[44] When they do revolve these accounts, small firms are not using these cards for changing the timing of consumption, but rather for investing in the firm's production. The title loan phenomenon is a good example.

Proprietors use these loans for operating capital. Small business owners use consumer lines of credit to invest in their businesses and therefore generate additional income. The way small business owners think about and use personal credit cards, home equity loans, and automobile title loans is very different from the mindset of regular consumers.

Small businesses typically rely on consumer loan products for two reasons. First, they frequently cannot obtain access to commercial lending products, which often (although certainly not always) carry lower interest costs.[45,46] A new small business owner is much more likely to be

[42] *Ibid.*

[43] The figure refers to 2003. "Report to the Congress on the Availability of Credit to Small Business," Board of Governors of the Federal Reserve System, October 2007, available at http://www.federalreserve.gov/boarddocs/rptcongress/smallbusinesscredit/sbfreport2007.pdf, at 30.

[44] According to the Survey of Consumer Finance 46.2 % of families had credit card balances outstanding in 2004. See Federal Reserve Board, Survey of Consumer Finance, 2007, available at http://www.federalreserve.gov/pubs/oss/oss2/scfindex.html.

[45] Smaller firms typically rely more on personal loans and personal credit cards than on commercial lending products. See Table A176 in Traci L. Mach and John D. Wolken, "Financial Services Used by Small Businesses: Evidence from the 2003 Survey of Small Business Finances," Federal Reserve Bulletin, October 2006.

able to get a $10,000 line of credit on a personal credit card than to get a $10,000 line of credit for a business from a local bank. Second, consumer loan products are often more convenient than other alternatives. New small business owners can dip into their own cash reserves, but that is risky since they may need those funds for daily living expenses or personal emergencies. Further, family and friends may not want to or be able to provide loans when needed, in the amount needed, or for the purposes it is needed. Borrowing from friends and family can also be considered humiliating and potentially damaging to personal relationships.[47] Entrepreneurs can sometimes obtain angel- or venture-capital funding, but they usually must give up a significant part of the upside of their business in the bargain.

V. The Effect of the CFPA on Small Business Financing

The proposed CFPA Act of 2009 would create a new federal agency to regulate consumer financial products and services. It would transfer the powers of existing federal agencies that enforce consumer lending laws to this new agency, provide considerable regulatory powers to the new agency, and would allow states and localities to adopt consumer protection rules more stringent than those adopted by the new agency.

A. General Effect of the CFPA on the Availability of Consumer Credit

If enacted, legal changes and accompanying uncertainty under the CFPA Act would likely make it more expensive for lenders to offer credit to consumers. Greater expense would result in lenders not making certain forms of lending available to some consumers that they would have made available in the absence of the CFPA Act.

[46] For example, the average short-term rate on business loans was 5.09%, whereas the 24-month rate on personal loans was 11.37% in 2008. For a historical time series of short-term business rates see Federal Reserve, "Bank Prime Loan, available at http://www.federalreserve.gov/releases/H15/data/Annual/H15_PRIME_NA.txt. For rates on 24-month personal loans see Federal Reserve, G.19 Release, September 8, 2009, available at http://www.federalreserve.gov/releases/g19/Current/.

[47] See Todd J. Zywicki, "The Case Against New Restrictions on Payday Lending," Working Paper (July 9, 2009), available at http://www.mercatus.org/PublicationDetails.aspx?id=27570.

Two legal changes would make lending a much more expensive proposition. First, the CFPA sets an "abusive" practices restriction in addition to the current "unfair and deceptive" practices restriction. There is extensive case law, and thus relative certainty on what is unlawful, under the current "unfair and deceptive" restriction. The "abusive" restriction in the CFPA Act is vague and there is no case law to provide certainty. Ultimately, such a standard would depend initially upon the views of the individuals in charge in the new agency and subsequent interpretation by courts. Lenders would face uncertainty as to whether their lending practices pass muster under the new law.

Second, the CFPA Act gives the states, as well as localities, the authority to issue more restrictive consumer protection regulations than those adopted by the CFPA. As a result, lenders would be subject to varying regulations and litigation exposure across the 50 states. The combination of these two changes means that lenders would face considerable risks from regulatory fines and litigation from extending credit. Such litigation, regulatory exposure, and uncertainty would raise the cost of financial products.

As an indication of what can happen with a new regulation, the history of the federal Truth in Lending Act is enlightening.[48] No financial regulation could be conceptually simpler—disclosure of costs and other terms of credit contracted for in a "clear and conspicuous manner" with federal preemption of state actions in the area.

Despite the conceptual simplicity and the sensible purpose it was designed to achieve, the Truth in Lending law quickly became a bureaucratic mess. In 1969, there were 34 official interpretations of the regulation one week before its effective date. A decade later, in June 1979, more than 13,000 Truth-in-Lending lawsuits had been filed in Federal courts, representing 2% of the Federal civil caseload, but up to 50% of the cases in some districts, according to the Administrative Office of the United States Courts. This produced a set of judicial decisions, interpretations, and reinterpretations, each of which could mandate costly new paperwork, procedures, and employee training. To settle arguments and reduce uncertainty (often caused by the lawsuits), the Federal Reserve Board and staff had published by early 1980 more than 1,500

[48] The statute is contained in the Title I of the Consumer Credit Protection Act, as mended (15 U.S.C. § 1601 et seq.), available at, http://www.fdic.gov/regulations/laws/rules/6500-200.html.

interpretations with varying degrees of legal authority.[49] That effort still could not prevent judicial disagreement, or resulting mandatory new legal directives, in large part because of uncertain legal authority of the interpretations. The mass of the material together with its technical nature and frequent changes have contributed to the growth of a very expensive industry of lawyers, consultants, trade associations, and printing and software companies to aid creditors trying to comply. And all this arose from a seemingly straightforward direction from Congress. The snowball effect of financial laws seen from the Truth in Lending Act example understates the potential consequences of the CFPA Act for paperwork and complexity because the Truth in Lending Act did not allow state and local authorities to issue additional regulations the way the CFPA Act proposes.

Even if there were no legal uncertainties, the CFPA itself would raise the cost of lending and likely have a negative effect on some products in several ways. The purpose of the CFPA is to engage in new and stronger regulation of consumer financial products, which likely means more restrictive regulations. First, the new agency would conduct reviews of loan products and could consider mandating the redesign of these products or their prohibition. Lenders would need to incur costs for these reviews, and it would seem likely, given statements by proponents of the CFPA, that lending options would be eliminated.[50] Second, the CFPA would require mandatory disclosures for financial products and these would need to be preapproved for new products that actually could merely be variations of existing products. These would raise the cost of introducing new products and possibly deter their introduction. Third, the CFPA would engage in the ongoing promulgation of rules and regulations that would likely raise the cost of lending.

In short, the CFPA regulation of loan products combined with the legal changes that allow states and localities to adopt more stringent consumer protection regulations, and that create a vague "abuse" standard would likely substantially raise the cost to lenders of making credit available. The new regulations of the CFPA would raise the fixed and variable costs of making credit available to consumers. The more credit a lender issues, the more exposure it has to litigation and other costs. But small lenders will be affected most by increased costs because

[49] See, generally Ralph J. Rohner, ed. The Law of Truth in Lending (Boston: Warren, Gorham and Lamont, 1984). See also, Jonathan M. Landers, The Scope of Coverage of the Truth in Lending Act, American Bar Foundation Research Journal (Volume 1, Number 2, 1976) and Jonathan M. Landers and Ralph J. Rohner, "A Functional Analysis of Truth in Lending," UCLA Law Review, April, 1979.

[50] Oren Bar-Gill & Elizabeth Warren, "Making Credit Safer," University of Pennsylvania Law Review, 157 (2008):39.

they do not have the scale to spread the increased fixed costs broadly. These increased costs would create pressure for lenders to raise the prices they charge in order to lend profitably.

It is also likely that the CFPA would cause lenders to withdraw some credit products from the market. In order to offer a loan product to a particular group of consumers, expected revenues must exceed expected costs by enough to provide a competitive profit after adjustment for risk. There are two reasons to believe that for some credit products, the CFPA would prevent lenders from earning enough profits on those products to make them available. First, the CFPA would raise costs of offering products and extending credit as mentioned above. It may not be possible for lenders to raise fees and interest rates enough to compensate for those higher costs in some cases. Second, the CFPA would also require lenders to offer standardized credit products—that the CFPA would design—to consumers before or at the same time as the lender offers its own version of these products.[51] There is no guarantee that the CFPA's standard product would be profitable. At the same time, the standard product could siphon off enough customers for other versions of that product offered by the lender that those versions lack enough demand to make them profitable. As a result, lenders may choose not to offer a product at all if they have to offer a standardized product alongside it.

Small businesses would therefore likely have less credit available to them, and higher-priced credit for the same reasons consumers would if the CFPA Act became law.

B. Impact of Reduced Credit Availability to Small Businesses

The financial needs of small businesses, and how they use consumer credit products, are different from those of ordinary, household consumers. Some small businesses have needs for credit that vary across the year in different ways than consumers. For example, landscape companies and wedding planners have seasonal business where they make the bulk of their sales within a short window of the year. Similar seasonal uncertainty is also true for art dealers, who may or may not make a purchase during an auction, and for whom resale of purchased pieces of

[51] See Section 1036(b)(1) in United States Department of the Treasury, Consumer *Financial Protection Agency Act of 2009* (2009), available at http://www.financialstability.gov/docs/CFPA-Act.pdf.

art may occur quickly or may take an extended period of time. That is true for repair contractors, tree surgeons, and snow removal companies, for example. What all these small business owners need is a flexible set of credit products that permit them to swallow short-term fluctuations in their credit needs, but not a large outstanding line of credit to be maintained all year long. These factors result in small business owners having different risk profiles and credit needs than ordinary consumers.

A major concern with the CFPA is that it would adopt a one-size-fits-all approach to credit products. It is likely that its regulations would cover all consumer loan products regardless of whether they are used by small businesses, and that its standardized products would be designed for the average consumer. Even if its approach were the right one for the average consumer, it is unlikely that its approach would be the right one for small business owners who have different needs and risks.

A couple of examples illustrate the concern. Consider auto title loans. Although the CFPA could not impose usury regulations, it could impose regulations that could reduce the usefulness of this product to small businesses. Although the contours of the CFPA's proposed power to regulate "abusive" lending products remains vague, it might empower the agency to ban the rollover of loan balances from one month to the next, prohibit the extension of more than a certain number of title loans to a given borrower within a given period of time, or require repayment according to installment schedules. For an independent small business that uses title loans as a source of flexible, short-term working capital, any of these restrictions could reduce the availability and usefulness of the product.

Home equity loans are another example. The CFPA could impose regulations that result in lenders not being able to make high-priced high equity loans available to high-risk consumers. One could suppose that doing so is appropriate for safeguarding consumers for whatever reason. Small businesses are in a different situation. A high-priced home equity loan may be a cheaper source of capital to them than obtaining angel investment funding and may be more convenient, and less personally painful, than seeking a loan from family or friends. The loan may also make the difference between being able to start a business—with the risky upside—and not being able to start a business. It is difficult to see how the CFPA could be sensitive to these differences between small businesses and ordinary consumers.

It appears likely that the CFPA, if created, would lead to a regulatory regime and a set of rules that would be incompatible with the needs of small businesses. Small businesses would face higher costs of credit and find that some credit products are not available to them for the reasons discussed above. The standardization of products that are geared toward the ordinary consumer could result in small businesses losing access to products that are the most sensible and affordable alternative for them.

VI. Conclusion

Census Bureau data show that new businesses, most of which are small, have provided much of the growth of employment in the American economy in recent decades. Federal Reserve Board data also show that small businesses often have difficulty finding necessary commercial financing. Credit turndowns are related inversely to size and age of the business, which indicates why many small businesses use consumer credit products for financing new business. These products notably include credit cards, as well as home equity credit lines, and other forms of traditional consumer credit.

The proposed Consumer Financial Protection Agency Act would, if enacted, likely cause disruptions in consumer credit markets due to extensive legal uncertainty arising from provisions of the proposed Act. It would apply an unclear "abusive" standard to prohibit products and practices without existing legal precedents for guidance, and it would permit state and municipal governments to form their own standards that might often conflict with the federal requirements. Both of these aspects of the Act are likely to raise the costs of producing consumer credit significantly and chill markets for consumer credit.

Even if the CFPA provides overall benefits to ordinary consumers, it is likely that small businesses, especially new ones, would face collateral damage. They would likely have less access to credit, not for consumption, but for building and operating their business, and would likely face higher costs for the credit they can obtain. That would be unfortunate because these firms are the ones that are the most important creators of jobs.

This is not the time to heap additional business difficulties on what has long been a highly dynamic part of the American economy. As outlined earlier, small businesses account for the bulk of new jobs in the economy and small businesses regularly use consumer credit products to smooth and finance the activities of the enterprises. A new regulatory regime that adversely affects this important economic sector with higher costs and new financial difficulties through unavailable products while that sector is struggling to overcome the aftermath of a significant recession is simply the wrong remedy at the wrong time.

Thomas A. Durkin

Thomas Durkin has specialized in the economics and regulation of consumer financial services in the federal government, academic, and private sectors. Before retirement in December, 2007, he was Senior Economist in the Division of Research and Statistics at the Federal Reserve Board where he has also been Visiting Professor. From 1988 to 1998 he was Regulatory Planning and Review Director in the Federal Reserve Office of the Secretary.

Durkin has also been Assistant and Associate Professor of Finance at Penn State University and Chief Economist and Director of Research of the American Financial Services Association. In that position he frequently testified on financial matters before Congressional Committees, spoke to business groups, and appeared on radio and television interview programs.

Durkin holds an A.B. degree from Georgetown University and a Ph.D. degree from Columbia University. He has published extensively in the field of financial institutions and especially consumer credit. He is co author of the textbook Financial Institutions and Markets and two books on consumer credit and Truth in Lending scheduled for publication by Oxford University Press.

NASBIC
America's Small Business Partners

September 23, 2009

Congresswoman Nydia M. Velázquez
Chairwoman
House Committee on Small Business
2351 Rayburn House Office Building
Washington, DC 20515

Congressman Sam Graves
Ranking Member
House Committee on Small Business
2361 Rayburn House Office Building
Washington, DC 20515

Dear Congresswoman Velázquez and Ranking Member Graves:

The purpose of this letter is to communicate the views of the National Association of Small Business Investment Companies (NASBIC) regarding the impact of restructuring the financial regulatory structure on small businesses. NASBIC applauds the Small Business Committee for holding this hearing.

NASBIC understands that a functioning and honest financial market is critical to the economy. Clearly there are areas of financial regulation that need reform. However, restructuring should address where the regulatory regime failed, but should not attempt to regulate what is not broken. Any restructuring should not add burdens that lack meaningful public benefit, particularly as it relates to small businesses.

Small Business Investment Companies (SBICs) are small, highly regulated private equity funds that invest exclusively in domestic small businesses and who are licensed by the Small Business Administration. Successes of small businesses that received investment from SBICs that have grown into American economic icons and employers include: Federal Express, Intel, Outback Steakhouse, Staples, and hundreds of NASDAQ listed companies. SBICs are regularly examined by federal regulators for financial reporting, regulatory compliance, investor diversity, investment diversity, and for many other criteria. As part of the SBIC license, the federal government has the ability to take strong action in the event of regulatory non-compliance or financial impairment.

The current proposals to restructure the financial regulatory system are intended to prevent and manage systemic risk. SBICs are far too small, most SBICs are smaller than 100 million dollars and all the SBICs combined are only a small fraction of the financial market. Despite the importance of the SBICs to small businesses and job creation, SBICs pose absolutely no risk to the financial system.

Despite posing no systemic risk, SBICs would be forced to register and be regulated by the SEC. This would be double regulation that would add no consumer or systemic protections. Double regulation would reduce capital to small businesses because it creates additional costs for becoming an SBIC. Most SBICs only have few employees, often only 5 or 6 employees. However, almost all would have to hire at least one additional compliance expert and additional lawyers with no added value to the SBIC. This is a significant cost with no benefit to small business.

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September 23, 2009
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In addition to direct impacts, the restructuring could inadvertently harm SBICs and therefore small businesses. Treasury proposal directs that banks should hold regulatory capital against all vehicles they sponsor. While it does not mention SBICs, they would be captured in this sweeping change. The result of including SBICs in this new capital charge would create disincentives to invest in SBICs. Previous legislation explicitly carved out SBICs from that provision because of their public policy benefit.

Given the money multiplying nature of SBICs, every dollar that a new regulatory regime diverts from SBICs is at least three dollars that will not go to American small businesses. NASBIC's member strongly encourage this committee to ensure that SBICs are not double regulated.

More broadly, the regulatory proposals would regulate all private equity funds with assets over $30 million dollars, many of whom are critical to the small business investment continuum. The entire spectrum of seed and venture funds through middle market buyout funds pose zero systemic risk. Creating new costs or restricting these funds will add no value to the public, hamper job creation, stifle innovation, and reduce domestic investment. All of these funds are critical resources to small businesses and hindering any one of them will negatively impact all them. Small businesses are already starving for investment capital and new regulation should not aggravate this problem.

One area where regulatory reform could be extremely constructive to small businesses is in the area of Community Reinvestment Act credits that banks earn. By practice, banks generally receive full dollar for dollar credit for investments in SBICs because SBICs invest exclusively in domestic small businesses. However, since the determination of CRA credit varies among regulatory analysts, clear statutory language granting full CRA credit for SBIC and small business investment would significantly increase the amount of capital available for domestic small businesses.

We encourage this committee to be a strong advocate for Small Business Investment Companies as regulatory restructuring makes its way through Congress.

Sincerely,

Brett T. Palmer
President